Rethinking Microfinance

Towards a Multi-Stakeholder Framework of Responsible Microfinance

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Abstract

Microfinance aims to better the livelihoods of the bottom of the pyramid by providing them with financial services. However, recent studies show that microfinance can have adverse effects, leading clients into over-indebtedness. This dissertation argues that microfinance clients are by default vulnerable and offers ways to rethink microfinance as client-centered, presuming a responsibility for client protection. Part I discusses the vulnerability of clients and the centrality of their protection. Part II analyzes the causes and consequences of over-indebtedness and suggests state regulations, financial literacy programs, and soft law standards for its mitigation. Part III introduces the concept of responsible microfinance, which claims that not only microfinance institutions but also other stakeholders, such as states and transnational and international organizations, have a responsibility to protect microfinance clients. Part IV accepts that over-indebtedness has to be addressed from several angles and considers how public and private actors may enhance its alleviation and develops an encompassing multi-stakeholder framework of responsible microfinance. Developing this framework includes a thorough evaluation of the suitability of ten novel strategies, such as behaviorally informed consumer protection regulations, educational soap operas, and Smart Campaign's Client Protection Principles, to further the mitigation of over-indebtedness.

Zusammenfassung

Mikrofinanz ermöglicht ärmeren Bevölkerungsschichten in Entwicklungs- und Schwellenländern den Zugang zu Finanzprodukten und beabsichtigt inkludierend und armutsbekämpfend zu wirken. Studien zeigen jedoch, dass Mikrofinanz auch negative Effekte haben kann. Ein zentrales Thema in dieser Debatte ist die Überschuldung. Diese Dissertation argumentiert, dass Mikrofinanz-Klienten aufgrund ihrer Verwundbarkeit eines besonderen Schutzes vor Überschuldung bedürfen. Von dieser Annahme ausgehend bietet diese Arbeit Anknüpfungspunkte um Mikrofinanz dahingehend zu überdenken, dass Mikrofinanz Institutionen klientenzentriert operieren und ihre Verantwortung, Klienten zu schützen, wahrnehmen sollen. Teil I diskutiert die Verwundbarkeit der Klienten und die Schlüsselfunktion des Klientenschutzes. Teil II beleuchtet die Ursachen und Auswirkungen von Überschuldung und schlägt Regulierungen, Massnahmen zur Förderung des Finanzwissens und Soft Law Standards zu deren Minderung vor. Teil III führt das Konzept Responsible Microfinance ein, welches eine Verantwortung der Mikrofinanz Institutionen und weiteren Stakeholdern im Bereich Klientenschutz annimmt. Teil IV entwickelt ein umfassendes Multi-Stakeholder Rahmenkonzept für Responsible Microfinance. Dabei werden zehn neuere Strategien öffentlicher und privater Akteure, wie z.B. verhaltensorientierte Regulierungen, bildungsstiftende Seifenopern und Smart Campaigns Klientenschutz Prinzipien auf ihre Eignung, Überschuldung zu vermindern, geprüft.

To my Grandmother Annie Landolt

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APR	Annual Percentage Rate
BoP	Bottom of the Pyramid
CGAP	Consultative Group to Assist the Poor
CFI	Center for Financial Inclusion
CI	Consumers International
DFID	Department of International Development
ECJ	European Court of Justice
ECOSOC	UN Economic and Social Council
ESG	Environmental, Social, Governance
EU	European Union
GAO	U.S. Government Accountability Office
GNI	Gross National Income
ILO	International Labour Organization
IMF	International Monetary Fund
IO	International Organization
MFI	Microfinance Institution
NGO	Non-Governmental Organization
NCP	National Contact Point
OECD	Organization for Economic Co-operation and Development
OHCHR	Office of the High Commissioner for Human Rights
O-I	Over-Indebtedness
PAR	Portfolio at Risk
ROI	Return on Investment
ROSCAs	Rotating Savings and Credit Associations
RQ	Research Questions
SC	Smart Campaign
SEBI	Securities and Exchange Board of India
SMEs	Small to Medium Size Enterprises
SPTF	Social Performance Task Force
WTO	World Trade Organization
UN	United Nations

UNCTAD	UN Conference on Trade and Development
UNDESA	UN Department for Economic and Social Affaires
UNGPBHR	UN Guiding Principles on Business and Human Rights
UNPCP	UN Guidelines for Consumer Protection
UNPRI	UN-Supported Principles for Responsible Investments

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INTRODUCTION

1 Inclusive Development Strategies, Microfinance, and Over-Indebtedness

With his statement that development strategies should aim for „build[ing] development around people rather than people around development" and that they should target the „productivity of the poor", Ul Haq's book *The Poverty Curtain – Choices for the Third World* heralded the start of a new perception that development strategies should be inclusive and orient themselves to the needs of the poor (1976, 28)[1]. The introductory paragraphs in the first United Nations (UN) Human Development Report of 1990 elucidated this novel perception further.

> *This Report is about people - and about how development enlarges their choices. […] No one can guarantee human happiness, and the choices people make are their own concern. But the process of development should at least create a conducive environment for people, individually and collectively, to develop their full potential and to have a reasonable chance of leading productive and creative lives in accord with their needs and interests. (Ul Haq 1990, 1)*

Microfinance, as a prominent example of an inclusive development strategy, tries to provide this conducive environment for the Bottom of the Pyramid (BoP)[2] to lead productive lives. Described as the process of

[1] His claims resonate with the later developed approaches known as the Capability Approach (Sen 2000a) or the Human Development Approach (Nussbaum 2011).

[2] „The term base or bottom of the pyramid [BoP] describes a consumer profile, as well as a portion of the financial market and financial services and products directed at this consumer profile. The consumer profile is characterized by a number of related and overlapping potential vulnerabilities including low or variable incomes, lower levels of financial literacy and capability, and limited access to or experience with formal financial services. Often, these characteristics correlate with other factors, such as lower education levels, illiteracy, language differences, minority racial or ethnic status, and longer distances from major population centers" (M. Chapman and Mazer 2013, 1). The term bottom of the pyramid (BoP) was first coined by Prahalad and Hart (2002; see also Prahalad 2010).

microfinance institutions (MFIs)[3] providing the BoP with different financial services, microfinance furthers financial inclusion[4] and eventually aims to lift the BoP out of poverty. Financial inclusion has gained momentum in recent years, and has become a considerably important subject for academia, policy makers and a wide array of stakeholders involved in development cooperation (Tilman et al. 2013, The World Bank 2014). Serving as a poverty reduction vehicle, financial inclusion is seen as an inclusive development strategy which aims to enhance the distribution of income by means of generating opportunities in the economic as well as in the social sphere (Chibba 2011, 78–79). The goal of financial inclusion is to widen and facilitate the poor's access to financial services.

Microfinance is one of the key strategies to enhance financial inclusion[5] and the object of this study. However, there is nothing trivial about furthering financial inclusion with microfinance. Microfinance, if not conducted responsibly, may bring about unintended and often adverse effects. One of the key messages of the Global Financial Development Report 2014 for Financial Inclusion is „[i]f inclusion is to have positive effects, it needs to be promoted responsibly. Financial inclusion does not mean credit for all at all costs" (The World Bank 2014a, 14). Microfinance was long perceived as a cure-all to reduce poverty in low- and middle-income countries in order to increase the poor's access to financial markets. Microfinance would enable the BoP to start or expand (mostly self-employed) businesses with a loan and become profitable. By means of

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[3] The term microfinance institutions (MFIs) is henceforth used interchangeably with the term microfinance providers.

[4] Financial inclusion is the opposite of financial exclusion. The latter refers to the process where people are prevented from „gaining access to the financial system" (Leyshon and Thrift 1995, 312). Over the past decades, financial exclusion has increasingly come to the attention of governments and international and transnational organizations, as a dimension to be taken into account in the fight against poverty and social exclusion (Dangi 2012, 70). The term social exclusion was coined by René Lenoir secretary of the social security department in France under the presidency of Valéry Giscard d'Estaing in the 1970s (see Lenoir 1974). Social exclusion can be understood as an umbrella term and includes financial exclusion. It is presented as one of the major problems today's development strategies attempt to fight. Sen (2000b, 1–2) provides a good overview of the usage of the concept of social exclusion and how it connects to and has taken root in the discourse about poverty and capability deprivation over the past 40 years.

[5] Other financial inclusion endeavors comprise financial literacy programs, promoting private-sector development, and regulatory and legislative support from governments.

microfinance the poor should also be able to smooth fluctuations in consumption as well as invest in education and health (Karlan and Zinman 2010, 436; Collins et al. 2011; Armendáriz and Morduch 2010). Especially the years 2005 and 2006 were important for the exceptional growth of microfinance markets. The Secretary General of the UN stated referring to the 'year of microcredit' in 2005:

> *[O]nce the poor were commonly seen as passive victims, microfinance recognizes that the poor people are remarkable reservoirs of energy and knowledge. And while the lack of financial services is a sign of poverty, today it is also understood as an untapped opportunity to create markets, bring people in […] and give them the tools […] to help themselves. (Kofi Annan, UN, Geneva Symposium, 10/10/2005)*

One year later as Muhammad Yunus, the founder of the renowned 'Grameen Bank' in Bangladesh, was awarded the Nobel Peace Prize, microfinance saw another boost and was identified as effective development assistance[6].

[6] Further reasons for the growing importance and the increased growth of microfinance for the past four decades are: *First*, empirical evidence from the field, despite its limitations in regard to generalization, suggests that microfinance has a positive impact on economic self-sufficiency (Karlan and Zinman 2010, 453). Setboonsarng and Parpiev argue, for example, that microfinance helps reaching the Millennium Development Goals (MDGs), especially the goal to half the number of people living on less than US$ 1 a day (2008, 1). *Second*, interest stems from an economic point of view. The fact that globally 50 percent of the adult population lacks a bank account, translates into an untouched market of 2.5 billion unbanked individuals (Demirgüç-Kunt and Klapper 2012, 2).

2 Rethinking Microfinance: Connecting Recent Developments and Insights to Explore New Avenues

After years of concentrating on growth and outreach of microfinance academics as well as individuals and groups of the private and public sector have started to evaluate the assets and drawbacks of microfinance more critically. Recent experimental studies have found that microfinance in fact has a limited impact on health, education and income (Banerjee, Duflo, and Kinnan 2015, 25–26). Furthermore, over-indebtedness as a pressing issue within microfinance has been prominently discussed in the media and especially in the case of the over-indebtedness crises in Andra Pradesh, India. Microfinance clients had taken up too much debt and had slid into over-indebtedness. Scholars have lately started to analyze the causes and adverse and wide-ranging effects over-indebtedness has not only on microfinance clients, but also on MFIs' financial sustainability, and the stability of microfinance markets. Additionally, they have investigated how over-indebtedness could be minimized.

Two research topics, however, have been widely left untouched. *First,* over-indebtedness as the most mediatized and as one of the pressing issues in microfinance showed the wide-ranging impact it has had on clients, MFIs, and markets to a wider public. While many authors investigate the phenomenon of over-indebtedness, no paper or publication, to the best of my knowledge, has yet addressed whether the devastating effects of over-indebtedness crises in combination with the other two core premises of microfinance, namely to follow a social mission, and to provide financial services to vulnerable clients, implies a rethinking of the current understanding and definition of microfinance. Arguing that microfinance clients should be protected from harmful practices and claiming that the connection between the current understanding of microfinance and the protection of its clients is a much more direct one, I advocate and propose an extended definition of microfinance including a quality-dimension demanding MFIs to abide by client protection standards. *Second,* although scholars propose ways to mitigate over-indebtedness from different angles and with different microfinance stakeholders (McKee, Lahaye, and Koning 2011; Guérin, Morvant-Roux, and Villarreal 2014; Brix and McKee 2010; Schicks 2010; Schicks 2011b; Schicks 2012; Kappel, Krauss, and Lontzek 2010; Johnson 2014; Hummel 2014; Guérin 2013; Guérin et al. 2014; Schicks and Rosenberg 2011; Wampfler, Bouquet, and Ralison 2014) the implications made in these publications had been seldom connected to and presented within an encompassing framework of coordinated and cooperated action to fight over-indebtedness. McKee, Lahaye, and Koning (2011) are among the few who make this connection. They propose a framework of responsible finance within which over-indebtedness can be mitigated from different angles and stakeholders. However and this holds for the few publications connecting responsible finance with microfinance, they do not clarify what 'responsible' or 'responsibility' in this context means. In the course of this research project, I advocate working towards a 'multi-stakeholder framework of responsible microfinance' that constitutes a specification of the broader and fuzzier framework of responsible finance. In doing so, I primarily elaborate the possible functions responsibility could have in such a framework. Thereafter, I present a framework of responsible microfinance including three pillars (i.e. state regulations, financial literacy programs, soft law standards) and analyze three to four cases for each pillar. These cases constitute tangible strategies to alleviate over-indebtedness among microfinance clients. The two overarching research questions of this study are therefore: On what grounds can an extension of the current definition of microfinance by a dimension accounting for how microfinance products should be delivered be advocated? And, what could a framework of responsible microfinance look like, and what are the potential functions 'responsibility' could take in such a framework?

In the succeeding chapter, I present the research design of this study, starting by introducing all of the research questions arising throughout this research project, briefly summarizing the arguments of the four parts it entails, and addressing the research methods used. I conclude by presenting the main goals this research project pursues and what contributions it could potentially make.

3 Research Design

This research endeavor is concerned with the overarching questions of what grounds there are to extend the current definition of microfinance, and how over-indebtedness, having serious and far reaching consequences not only for clients but also for MFIs and microfinance markets, can be mitigated. Additionally, there are further research questions that arise throughout the course of this research project. All the research questions are introduced below. Please note that in each of the four parts of this study the corresponding research questions will be separately introduced once more and a short literature review will be presented. In order to provide possible answers to the following research questions, my arguments are based on theories, insights, and empirical evidence from the fields of political science and philosophy, economics, behavioral economics, psychology, law, and ethics.

3.1 Introducing the Research Questions and the Structure of this Research Project

Hereafter, I briefly elaborate on all research questions that arise throughout this research project and provide a summary of the arguments brought forward in each of the four parts constituting this study.

RQ I Although the main premise of microfinance is to be financially profitable and to help clients better their livelihoods, recent studies have shown that microfinance in fact also could have adverse effects that may leave microfinance clients over-indebted. Scholars and practitioners alike call for enhanced protection of microfinance beneficiaries. This demand is so comprehensive that the question arises whether protecting microfinance clients from harmful practices is so substantial that the current definition of microfinance should be revised and extended by the requirement to adhere to client protection standards (i.e. quality-dimension). The first research question, which is discussed in Part I of this study is the following: *On what grounds can an extension of the current definition of microfinance by a dimension accounting for how microfinance products should be delivered be advocated?*

RQ II Assuming that there are grounds to extend the microfinance definition by a quality-dimension accounting for the better protection of microfinance beneficiaries when provided with financial services, Part II demonstrates that due to the manifold and intertwined reasons for over-indebtedness, it is not sufficient to 'only' require MFIs to abide by client protection standards. Rather the question arises whether there is a range of approaches that could contribute to the lasting mitigation of over-indebtedness, MFIs delivering a certain quality of products being just one of them. The second research question, which is discussed in Part II of this research project, is: *What are the causes and consequences of over-indebtedness and what approaches could be suited to mitigate over-indebtedness from different angles?*

RQ III The analysis of Part II reveals that there are mainly three approaches to fight over-indebtedness: state regulations, financial literacy programs, and soft law standards. The main goal of Part III is to argue that the extended definition developed in Part I in combination with the three approaches deduced from the over-indebtedness analysis in Part II could be connected to an encompassing multi-stakeholder framework of responsible microfinance. However, responsible microfinance is a young and fuzzy concept that still lacks a common definition and literature further neglects to concretize what 'responsibility' in the context of microfinance could mean. The third research question, which is discussed in Part III of this research project, is therefore: *What is responsible microfinance and how could responsibility be interpreted in this context?*

RQ IV & V Defining and concretizing the concept of responsible microfinance facilitates the development of a multi-stakeholder framework of responsible microfinance, which stands on three pillars (e.g. state regulation, financial literacy programs, soft law standards). In Part IV, I explore and elaborate on practical cases that mitigate over-indebtedness in regard to each pillar to illustrate how responsible microfinance could be enhanced and enforced. The fourth and fifth research question, which are discussed in Part IV of this study, are as follows: *What could a framework of responsible microfinance look like? What are the possible actors involved and which practical strategies to mitigate over-indebtedness could they further?*

Short Summary of Argument – Part I

MFIs are extending credit to low- to zero-income clients, who cannot show any collateral. Therefore, MFIs have to use a business model accounting for the risks of providing uncollateralized loans, and at the same time manage the information asymmetries underlying traditional loan contracts. Having no securities in case of a defaulting client requires MFIs to use specific group- and individual lending methodologies, which help MFIs to prevent their clients from defaulting.

In the 1990s, microfinance markets registered unprecedented growth and soon microfinance was talked about being the most encouraging poverty reduction vehicle. However, MFIs started to ease their lending practices in order to enlarge the outreach and profitability of their business, which eventually led to clients taking on more debt than they could manage. These developments peaked in a few microfinance markets suffering over-indebtedness crises[7], which served as a demonstration showing that after all the 'microfinance promise' of the 1990s did not hold true. The failed microfinance promise and the realization that clients suffered greatly from over-indebtedness made scholars and practitioners alike demand enhancing the protection of microfinance beneficiaries. Accounting for this call the question whether the protection of microfinance clients is so substantial that extending the current definition of microfinance becomes necessary to be investigated. To substantiate that in fact the definition of microfinance should be extended in such a way that microfinance should not only be defined in regard to what kind of products microfinance entails, who the target group is and who provides the services, but also how they are supplied or which quality they have, three arguments are brought forward.

I. *The Vulnerability of Clients*

People living at the BoP are much more vulnerable to seemingly normal life events and to external shocks than people living above a certain income level. By discussing the dichotomy between average and vulnerable clients, it surfaces that microfinance clients are by default vulnerable clients and need „a higher level of protection" (Benöhr 2013, 17).

[7] Microfinance markets that underwent repayment crises were Bolivia (1998-1999), Colombia (1999-2000), South Africa (1999-2002), Morocco (early 2008), Bosnia and Herzegovina (2008), Pakistan (late 2008), Nicaragua (2009-2010), India (2010) and Chile (2010-2011) (Chen, Rasmussen, and Reille 2010, 1; Davel 2013, 12).

II. *The Social Mission of MFIs*

The social mission of microfinance is the cornerstone of this business model. Since the early days of microfinance the double bottom line[8] has been the constitutive element of microfinance. Owing to their social mission MFIs should therefore apply certain measures to protect their clients from harmful practices.

III. *Over-Indebtedness Crises*

The causes triggering over-indebtedness crises are diverse and intertwining. Contrasting with the beliefs of the 1980s and 1990s, academics as well as individuals and groups in the private and public sector started realizing that microfinance may in fact produce adverse effects and they have recently commenced to assess the advantages and disadvantages of microfinance more critically. One special focus has been directed at the causes and consequences of over-indebtedness and what promising ways there are to minimize the probability of getting over-indebted. The principal suggestion from scholars is to increase the protection of microfinance clients.

On the grounds of these three arguments, I advocate a rethinking of what microfinance defines in such a way that a quality- or how-dimension[9] is included into the current definition of microfinance. The extension of the definition of microfinance creates a general understanding that microfinance ought to be carried out within certain boundaries, to which I refer in Part I as consumer or client protection. Encouraging that microfinance products should be provided in accordance with client protection standards, I set a benchmark how the quality-dimension could be evaluated. Justifying that the adherence of MFIs to client protection standards while supplying financial products is a fundamental feature of microfinance is the main goal of Part I.

[8] Helping the BoP out of poverty by providing them with financial services and at the same time aiming for profitability is known as the double bottom line of microfinance.

[9] I henceforth use the terms quality-dimension and how-dimension interchangeably.

Short Summary of Argument – Part II

In Part II of this research endeavor further implications of the extended definition of microfinance are elaborated. Starting from the assumption that the reasons for microfinance clients struggling with too much debt cannot be solely accounted to the malpractices of MFIs, a detailed analysis of the causes and consequences of over-indebtedness, not only on the MFI but also on the client and market level, helps to assess whether including the quality-dimension into the definition of microfinance lastingly protects clients from the risk of unmanageable debt or if there is need for a more comprehensive and protective framework. Accounting for the many causes and wide-ranging consequences that over-indebtedness has and brings along, it is recommended that microfinance stakeholders could alleviate over-indebtedness from various perspectives. The analysis reveals that there are three promising approaches suitable to counter over-indebtedness: state regulation, financial literacy programs, and soft law standards. To protect microfinance clients effectively from over-indebtedness, it is insufficient to extend the current definition of microfinance. Analyzing the causes and consequences of over-indebtedness in Part II suggests working towards and conceptualizing a broader framework, which includes all relevant microfinance stakeholders and calls upon them to take the responsibility necessary when doing business with the BoP. Such a framework will be developed in Part III and further discussed in Part IV.

The in-depth analysis of the manifold and intertwined causes and consequences of over-indebtedness emphasizes the centrality over-indebtedness takes in microfinance and gives leeway to thinking about connecting the extended definition of microfinance, which requires MFIs to protect their clients from harmful practices, to an encompassing multi-stakeholder oriented framework including tangible strategies to fight over-indebtedness.

Short Summary of Argument – Part III

In Part III, I connect the extended definition of microfinance with the comprehensive and multi-stakeholder oriented framework of responsible microfinance. The concept of responsible microfinance has only surfaced in the past few years and presupposes that due to the vulnerability of microfinance clients, microfinance's social mission, and the threats over-indebtedness pose to the client's well-being, the MFI's financial sustainability and the systemic stability, microfinance stakeholders have a responsibility to mitigate over-indebtedness. What this responsibility could mean, however, is neglected by literature. The possible functions which responsibility could take within a framework of responsible microfinance are left undefined. Therefore, the aim of Part III is to further define and concretize the concept of responsible microfinance, and to underpin the framework with an approach to responsibility to spark a debate about how narrow or wide this responsibility shall be interpreted in the context of responsible microfinance.

Responsible microfinance is developed as having an overall demand for enhanced responsibility when doing business with vulnerable clients. Additionally, responsible microfinance has three more specific demands: MFIs balance their financial and social performance (1), stakeholders should contribute to enabling and enforcing responsible microfinance (2), and MFIs should hold themselves responsible for their social mission (3). Whereas the first two demands will be elucidated in Part IV, Part III is concerned with the overall demand for responsibility within microfinance and the specific claim that MFIs should hold themselves responsible for attaining their social mission. In Part III a definition of responsible microfinance is developed and a definition of 'responsibility' is provided. Furthermore, a main focus is put on the question whether MFIs as group agents can be held responsible.

The concept of responsible microfinance is still in its infancy and needs more work, nevertheless concretizing and defining how responsibility could be interpreted in this context contributes to the discussion about how responsible microfinance might evolve and further develop. In Part III, by defining and putting into context what responsibility could mean I aim to provide responsible microfinance with a foundation. Having an approach to responsibility narrows down the interpretational range of what responsible microfinance is. A common understanding of responsible microfinance would lead to translating a fuzzy practical into a definable concept, which might also be used in more theoretical work.

Short Summary of Argument – Part IV

Whereas Part III focuses on the overall demand for responsibility in responsible microfinance, Part IV is concerned with elaborating on the remaining two demands of responsible microfinance calling for balancing the financial and social performance, and enabling and enforcing responsible microfinance. Therefore, I explore and elucidate on the three pillars of responsible microfinance (i.e. state regulations, financial literacy programs, soft law standards). Analyzing three to four practical cases for each pillar provides the framework with tangible strategies to alleviate over-indebtedness among microfinance clients.

I. State Regulations

Three cases in the realm of state regulations that potentially mitigate over-indebtedness and enable and enforce responsible microfinance are explored. *First*, I elaborate on behaviorally informed consumer protection regulations with a focus on disclosure requirements, fair treatment and recourse mechanisms (Case I). *Second*, credit bureaus and their potential to prevent cross-borrowing are explored (Case II). *Third,* I dwell on the widely neglected topic of how private insolvency systems could help to provide over-indebted microfinance clients with a 'fresh start' (Case III).

II. Financial Literacy Endeavors

Three cases of how financial literacy programs can enable and enforce responsible microfinance and therefore mitigate over-indebtedness are discussed. *First,* the financial literacy program of SEWA Bank (India), which uses in-depth knowledge about their clients to assess their financial situation and financial literacy level, is presented (Case IV). *Second,* 'Makutano Junction', a Kenyan soap opera, is introduced as a way to educate microfinance clients and raise awareness of and thereby have the potential to mitigate over-indebtedness among viewers (Case V). *Third,* digital games as a possibility to educate clients about the risks and costs of microfinance products are addressed (Case VI).

III. Soft Law Standards

Four cases of how soft law standards enable and enforce responsible microfinance and prevent over-indebtedness are analyzed. *First,* the UN Guidelines for Consumer Protection with a specific focus on the newly added financial services chapter are elucidated (Case VII). *Second,* the UN Guiding Principles on Business and Human Rights are discussed (Case VIII). *Third,* Smart Campaign's Client Protection Principles and Certification Program, which is specifically aimed at protecting microfinance clients from over-indebtedness, is analyzed (Case IX). *Fourth,* The Social Performance Task Force's Universal Standards of Social Performance Management, which are the most encompassing soft law standards targeted at microfinance as well as the most demanding ones, are addressed (Case X).

In Part IV of this research project, I develop and present a comprehensive multi-stakeholder framework of responsible microfinance within which individual, as well as institutional and systemic risks connected to over-indebtedness among microfinance clients, can be alleviated. I analyze ten cases that represent practical strategies of how responsible microfinance as a coordinated and cooperative effort of multiple microfinance stakeholders can be enabled and enforced.

3.2 Methods

Extending the definition of microfinance by adding a quality-dimension and connecting this understanding of microfinance to an encompassing multi-stakeholder framework of responsible microfinance I break new ground and contribute to and concretize a conception of microfinance that orients itself to the well-being of its vulnerable clients. This research area is understudied and therefore also the research method is largely explorative. Insights and results from explorative studies that use less structured methods are limited in regard to generalization. Generally, explorative studies trade generalizability and comparability for an in-depth and contextual understanding of the studied phenomena and higher internal validity (Maxwell 2013, 88).

In order to elaborate on the research questions in Part I to III, I conduct a secondary source analysis. Hence, I consider secondary sources, such as qualitative, quantitative, and theoretical publications, and draw inferences in regard to the current research questions. To investigate the research questions of Part IV, especially when analyzing the ten cases to enhance and enforce responsible microfinance, I mainly use primary sources. Primary sources that are examined in this regard are, for example, documents, presentations, reports, minutes, soft law standards, covenants, regulations, and working group transcripts. If there are secondary sources discussing the same, or similar primary sources, I refer to them to substantiate my conclusions.

3.3 General Discussion of Availability of Data and Literature

As discussed in other microfinance publications, data availability in the field of microfinance is an issue, especially in regard to the topic of over-indebtedness (see for example Kappel, Krauss, and Lontzek 2010, 2). This is mostly due to small sample sizes preventing the possibility of generalizing results. Furthermore, there are only a few academic research papers discussing over-indebtedness in microfinance (see for example Guérin, Morvant-Roux, and Villarreal 2014; Morvant-Roux et al. 2014; Schicks 2012). Most of the literature debating and analyzing over-indebtedness in microfinance include policy papers and reports commissioned by international or advocacy organizations (see for example Ardic, Ibrahim, and Mylenko 2011; Brix and McKee 2010; Forster et al. 2010; CGAP 2012; Chen, Rasmussen, and Reille 2010). In regard to responsible microfinance there are, to the best of my knowledge, no academic research papers so far and only a few policy papers and reports (McKee, Lahaye, and Koning 2011; Chien 2012; Koning and McKee 2011; Koning and Wardle 2014; Responsible Finance Forum 2011; Haebig and Gross 2012). The scarcity of secondary and primary sources has challenged this research project insofar as the generalizability and the comparability of the results of this study are very limited.

In the following, I separately discuss the research outline, case selection, and data quality and availability for Part IV where I analyze ten practical cases of how over-indebtedness can be mitigated within a framework of responsible microfinance.

3.4 Separate Discussion of Research Outline of Part IV

Part IV explores practical cases for each of the three pillars of the multi-stakeholder framework of responsible microfinance (i.e. state regulations, financial literacy programs, soft law standards). For Pillar I and II, I present three cases and for Pillar III, I present four cases that shall illustrate practical strategies to mitigate over-indebtedness among microfinance clients. By means of a thick description, I conduct ten single case studies. Whereas I discuss the Cases I to VI of the first and second pillar in detail, I put an in-depth focus on the Pillar III (i.e. soft law standards).

The four soft law standards that I analyze in Pillar III have one common characteristic, namely that they all have established part or all of their standards by consulting with an array of stakeholders. Resonating with the introductory paragraphs at the beginning of this research project, advocating an understanding of microfinance that should be oriented towards the client, and elaborating more on the consultative and participatory elements of soft law standard setting, I evaluate four hard cases of soft law standards against the common interest regulation theory by Mattli and Woods (2009) (see Chapter 19).

3.4.1 Case Selection

The main goal of Part IV is to analyze ten practical cases that contribute to the mitigation of over-indebtedness. The chosen cases should offer data available to analyze their impact on the alleviation of over-indebtedness. Optimally, the cases are well documented and secondary but especially primary sources are available. Furthermore, the selected cases have to be of „practical relevance and social importance" (Blatter and Haverland 2012, 102). All of the ten cases are hard cases due to their importance, pioneering role, or uniqueness in regard to their contribution to the mitigation of over-indebtedness.

3.4.2 Availability of Data

Cases I to VI are well documented and there are secondary and primary sources available for a detailed description. As the focus lies on the soft law standard cases (Cases VII-X) also the data availability in this regard is crucial. Cases VII to X – the UN Guidelines for Consumer Protection, the UN Guiding Principles on Business and Human Rights, the Smart Campaign's Client Protection Principles and Certification Program, and the Social Performance Task Force's (SPTF) Universal Standards of Social Performance Management – are very well documented and there is substantial information about the stakeholders involved. There is furthermore a delineation of who is actually taking decisions and thus involved in the decision-making processes. In order to conduct the case studies I will mainly draw on primary data sources.

Although data availability is good, there is mainly one challenge to face throughout this research endeavor. Microfinance is still a young, ever-growing, and changing field of research. During the research period, internet resources, such as minutes, datasets, reports, and policy papers were not accessible any longer under the same title or URL address not only due to updates but also because certain websites were not online anymore.

3.5 Goals of this Research Project and Potential Contribution

The main goals and contributions of this research project are twofold. *First* and foremost, I develop and concretize a framework of responsible microfinance that presents tangible strategies of how to fight over-indebtedness from different angles. The *second* contribution is that the proposition of such a framework however presupposes the rethinking of what elements actually define microfinance. Without an understanding of microfinance, which accounts for the vulnerability of microfinance clients, the social mission of MFIs, the reaction to over-indebtedness crises of late, and therefore the demand that microfinance be conducted in certain boundaries (i.e. quality-dimension), the framework of responsible microfinance would lose a part of its foundation.

In the concluding Chapter 21, the goals of this study are recapitulated, the study's results and its overall contribution are discussed, and its implications and direction for future research are addressed.

PART I – MICROFINANCE: ADDING A NEW DIMENSION

4 Bringing Financial Services to the Poor

Microfinance includes the provision of small-scale financial services to individuals living at the BoP. In the optimal case, microfinance presents us with a win-win situation. On the one hand, microfinance has a social mission aiming to empower its clients in different respects and may eventually enable them to permanently escape poverty. On the other hand, MFIs earn money by providing the BoP with financial services that may grow and expand their businesses. This might ultimately have positive effects on the economic growth of a region or a country as a whole. However, recent over-indebtedness crises in microfinance markets have revealed that positive impact does not always materialize and that reality greatly differs from the often-suggested optimal case. As will be later discussed in greater detail, microfinance markets in Bolivia, Colombia, South Africa, Morocco, Bosnia and Herzegovina, Pakistan, Nicaragua, India and Chile were seriously shaken or collapsed entirely (Chen, Rasmussen, and Reille 2010, 1; Davel 2013, 12). Crises were caused by aggressive commercialization of the microfinance sector combined with not only abusive lending practices, concentrated market competition, political interferences but also non-repayment movements. These were the main triggers that led microfinance clients into over-indebtedness. Seemingly it is the potentially vulnerable microfinance clients that have to notice and bear the detriments of such crises the most.

Since microfinance crises imply wide-ranging and devastating consequences, especially on the client-level, scholars and practitioners alike called upon an array of stakeholders to combating the various causes of over-indebtedness mainly through increasing consumer and client protection[10] (Guérin, Morvant-Roux, and Villarreal 2014; Schicks 2011a; Schicks 2011b; Schicks 2012; Schicks 2010; Chien 2012; Brix and McKee 2010). Recent over-indebtedness crises revealed two pressing issues. *Firstly*, microfinance clients are rather vulnerable than average clients and need to be better protected from harm. *Secondly* and despite microfinance providers' social mission, over-indebtedness crises revealed malpractices on the providers' side letting clients slide more easily into over-indebtedness. In the light of past over-indebtedness crises and accounting for the demand for enhanced client protection it is questionable whether the current definition of microfinance captures these recent developments. On what grounds could an extension of the current definition of microfinance by a dimension accounting for how microfinance products should be provided be advocated?

The first part of this research project pursues two goals. *First*, a general overview of microfinance and its workings is presented (Chapter 4 and 5). *Second*, the current definition of microfinance as introduced in Chapter 5.1 will be challenged and extended (Chapter 6 and 7).

Part I is structured as follows: Providing financial services to the BoP is no simple task. Chapter 4.1 explains the difficulties of investing into low-income countries in general and what specific problems (e.g. information asymmetries, no collateral) microfinance providers face when trying to invest into micro businesses. Chapter 4.2 entails a short outline of the evolvement of microfinance, discussing how different initiatives for improved protection of microfinance clients developed and gained importance after the 'microfinance promise' of the 1990s did not hold true.

For a general understanding of microfinance and its vocabulary, which is a prerequisite for every part of this research project, and particularly to appreciate the centrality of client protection in microfinance, it is key to have knowledge about the functions and difficulties of microfinance. Chapter 5 therefore provides an overview of what microfinance currently defines, what it entails, and who its providers are. A particular focus is

[10] Henceforth, I will use the terms client protection and consumer protection interchangeably.

given to the most common product of microfinance, which is credit. Credit relationships between clients and microfinance providers are always characterized by asymmetric information. Referring to the problems of adverse selection and moral hazard, it is explained how microfinance providers overcome these information asymmetries by applying specific lending methodologies. This knowledge later serves as a foundation to understand that specific lending methodologies might not be sufficient to protect microfinance clients effectively from over-indebtedness.

Chapter 6 presents the arguments to extend the current definition of microfinance by a quality-dimension. Three points are particularly important in order to advocate the extension of the definition of microfinance: the vulnerability of microfinance clients (1), the inherent social mission of microfinance (2), and recent over-indebtedness crises (3). These three arguments stand for the importance of how microfinance products should be provided and all three bear implications for how a microfinance provider should actually supply its financial products to the BoP. The extended definition is presented in Chapter 7 and against the backdrop of the three arguments demands microfinance providers building client protection into all of their services. The extended definition therefore considers client protection as essential to the definition of microfinance.

4.1 No Information, No Collateral, No Business?

> *To argue that banking cannot be done with the poor because they do not have collateral to offer, is the same as arguing that men cannot fly because they do not have wings. Men have the singular distinction, among all animals, of being extra-ordinarily innovative. Until the recent past in history nobody ever believed that men will really fly. Today not only do they fly, they fly at a speed and to a distance, which boggles anybody's mind. Now to argue that this innovative animal cannot design a banking system, which does not rely on collateral is simply an insult to human ingenuity. (Yunus 1992a, 75)*

Basic economics teaches that a relatively poor entrepreneur is able to make significantly higher returns on her invested capital than a richer entrepreneur. Therefore, she will be also able to pay higher interest rates on loaned money than richer entrepreneurs. The concept is simple: If an entrepreneur invests more money in her business, she has higher returns on her invested capital. However, every time she invests more capital into her business the marginal return on capital will diminish. A street vendor taking out a loan to sell her own fruit needs for example to buy a simple scale in order to weigh the fruit and calculate the price. Besides the scale she might have to invest some of that money in seeds, fertilizer and a rake. After some time she wants to expand her business. She engages a carpenter to build her a small, colorful booth that is lockable and where she can store fruit. The booth attracts a lot of customers and after six months she is ready to hire her first employee. With every investment, she expands her business and also earns more money, but she produces less gains on the money invested. An entrepreneur just starting her business will always have a higher marginal return to the capital invested than an entrepreneur owning a business that has already reached a certain size. Following this logic, poor entrepreneurs should not have any problems to fund their business. Hence, money should run from commercial banks to business projects of the BoP, or on a bigger scale and more generally put from north to south. Why then can we not observe this shift? Armendáriz and Morduch (2010, 5) ask why capital does not naturally flow to the poor and the answer is plain: No information, no collateral, no business - at least no conventional business.

Investing in low-income countries with weak legal frameworks, bad infrastructure (e.g. roads, electricity) or unstable political systems for a high return on investment (ROI) is in general far riskier than investing in a middle- to high-income country with a reliable legal system, good infrastructure and a stable political environment even though the ROI might be comparatively small. The same holds true in regard to investing in micro-businesses of street vendors or seamstresses in low-income countries. Clients cannot show any collateral that the financial institution could seize in case of default. Financial institutions furthermore do not have enough reliable information about the client to assess his or her creditworthiness. Is she going to use the money for the project she said she would use it for? Will she be able to pay back the loan as scheduled or will she take the money and run? Unless the financial institution is able to collect more information about the investee or seize collateral in case of default, it remains a high-risk business. Additionally, lending to poor communities is expensive. Often clients live in remote areas that are not easily accessible by car or motorcycle. Thus, transaction costs (TCs) are high, which renders the provision of financial services to these clients very costly. Microfinance promises to fulfill the task of efficiently delivering financial services to poor communities, finding a remedy for agency problems [11], and providing these services at a relatively low price (Armendáriz and Morduch 2010, 5–9).

[11] These remarks describe the problem of information asymmetries between investor and investee and will be discussed in detail in Chapter 5.3.2.1.

4.2 From Promises to Reality: Client Protection as a Pressing Issue When Providing Financial Services to the BoP

Tackling financial exclusion with credit was already a well-known, yet unsuccessful strategy used by governments from the 1950s to the 1980s (Morduch 1999, 1570; Terberger 2003, 189). Government endeavors to help eradicating poverty with highly subsidized „credit-gifts" have failed miserably and credit did not find its way to the actual target groups (see for example Vogel 1984, 142–143). However, in the 1980s and 1990s a new set of financial institutions, which aimed to provide the poor with financial services, gained momentum. While still being dependable on subsidized funding and grants in a first phase, these pioneering microfinance providers soon strived for financially sustainable business models. Traditionally, they have a social mission – i.e. providing the BoP with financial services and help them out of poverty – and at the same time they aim to reach profitability (see for example Robinson 2001, 8). These two goals of microfinance are generally referred to as the double bottom line. Besides the positive effect of eradicating poverty, policy makers either emphasized how microfinance gives poor people the incentive to be productive and being less or not dependent on aid of the state, civil society or the international community, or highlighted the bottom-up aspects of microfinance, emphasizing the „attention to community, focus on women, and the aim to help the underserved" (Morduch 1999, 1570).

That microfinance creates a win-win solution for both, poor clients and microfinance institutions, was widely acknowledged in the 1980s and 1990s. Hence, this 'Microfinance Promise', a term coined by Jonathan Morduch (1999), provided policy makers and practitioners with the keywords they needed in order to bring microfinance into prominence and attract investments. However, the above-described assumptions about the positive effects of microfinance not only on the individual but also on the institutional and the macro level might only accrue if we simulate an ideal case. In the late 1990s and 2000s researchers, practitioners and public officials started to learn that the microfinance promise did not always pertain against the backdrop of the accelerating commercialization of the microfinance sector, competitive microfinance markets, the low educational level of clients, the inexperienced MFI staff, the incentive driven salary systems for loan officers and the too restrictive or too lax regulations. To the most part, and this particular topic is discussed in more detail in Part II, it was the microfinance clients that bore the detriments caused by these developments. In the mid to late 2000s slowly a debate about how microfinance clients should be protected against abusive practices picked up pace and peaked when different initiatives were launched to promote client protection. The three main ones are:

- MFTransparency (2008)
- Smart Campaign (2009)
- Social Performance Task Force (2005)

In 2008 MFTransparency[12] was founded. It focuses on pricing transparency in microfinance and provides tools and information about how MFIs should display prices comprehensibly for poor clients. It envisages microfinance markets where clients are able to make informed decisions. In 2009, an institution to foster consumer protection called Smart Campaign was launched by the Consultative Group to Assist the Poor (CGAP)[13] and the Center for Financial Inclusion (CFI)[14]. In July 2011, Smart Campaign

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[12] For more information please see http://www.mftransparency.org, especially the Calculating Transparent Pricing Tool http://www.mftransparency.org/resources/calculating-transparent-pricing-tool/ [last accessed 26.01.2016].

[13] „CGAP is an independent policy and research center dedicated to advancing financial access for the world's poor. It is supported by over 30 development agencies and private foundations who share a common mission to alleviate poverty. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions and offers advisory services to governments, financial service providers, donors, and investors" (http://www.cgap.org/p/site/c/aboutus/ [last accessed 25.01.2016]). CGAP is located at the World Bank in Washington DC.

[14] „CFI works through a collaborative business model: it forms or connects with groups of key industry participants who come together to address selected challenges. Working with those groups, it applies the most appropriate tools from a toolbox that includes convening, research, publications, campaigns, piloting and knowledge-dissemination. In selecting its program areas, CFI seeks out areas that have a strong fit with its vision of financial inclusion – particularly its emphasis on quality. It looks for aspects of that vision that have been under-addressed by others and where CFI may have a comparative advantage based on its industry relationships and areas of existing competence (http://www.centerforfinancialinclusion.org/ [last accessed 25.01.2016])." CFI is located at Accion (a global non-profit organization engaged in microfinance) in Washington DC.

introduced seven 'Client Protection Principles'[15], which should serve as a standard with soft law character, meaning that the standards are voluntary. As a follow-up to the Client Protection Principles, Smart Campaign developed a third-party certification that should account for rendering the principles more enforceable (The Smart Campaign 2014). In 2005, CGAP, the Argidius Foundation, and the Ford Foundation founded the Social Performance Task Force (SPTF)[16]. Although primarily concerned with social performance of MFIs (i.e. reaching a double bottom line), they consider client protection an inherent element of social performance and endorse it by including the Smart Campaign's Client Protection Principles in their Universal Social Performance Standards (Social Performance Task Force 2014a). These three initiatives were a reaction to different over-indebtedness crises and other abusive practices in microfinance. They stand for the recognition that client protection is pivotal on the one hand to safeguard the continuity of microfinance and on the other hand to promote equal treatment of microfinance clients.

[15] Smart Campaign, its Client Protection Principles and Certification Program will be discussed in detail as Case IX in Chapter 19.4.

[16] SPTF will be discussed in detail as Case X in Chapter 19.5.

5 Microfinance: An Overview

In order to better understand what microfinance is and entails, this chapter provides an overview of microfinance, its current definition, its target groups, service providers, and its products. In regard to microfinance products, the focus is put on the main financial service MFIs provide: credit. For more information on additional microfinance products, such as savings, insurance, and money transfer, please see the Appendix. Also the various investors involved in funding MFIs' lending operations are summarized in the Appendix.

5.1 A Current Definition of Microfinance

In literature, one can find a wide array of microfinance definitions. Whereas recent literature makes use of broad and brief definitions (Armendáriz and Morduch 2010, 5), the ones of the late 1990s were narrow and exclusive (Robinson 2001, 41–42). A definition of microfinance should be broad enough to include the different types of MFIs operating in this field at the moment and narrow enough to describe what kind of services they provide and what should be the highest outstanding balance for a client that is still to be considered microfinance.

In the following, I present a definition combining a qualitative and quantitative approach to define microfinance. The qualitative part of the definition of microfinance entails the description of the financial services, target group and types of institutions providing the financial services and is based on Robinson (2001, 9–10). The quantitative part is borrowed from The Mix[17]. The Mix publishes microfinance analyses on a regular bases and for this reason they apply an operationalizable definition factoring in the

[17] The Mix is a microfinance information exchange site, where most of the data used today for microfinance research is taken from. MFIs can report their data (e.g. numbers of clients, regulation status, accounting data, average loan size) to The Mix and interested parties may access this information. The complete microfinance definition of The Mix reads as follows: „Microfinance services – as opposed to financial services in general – are retail financial services that are relatively small in relation to the income of a typical individual. Specifically, the average outstanding balance of microfinance products is no greater than 250% of the average income per person (GNI per capita) (The Mix 2010)."

outstanding balance. This definition is of special relevance because they relate the outstanding balance to geographical regions by specifying that the outstanding balance[18] should not exceed 250 percent of the average income per person (GNI per capita)[19]. Therefore, a current definition of microfinance may read as follows:

> *Microfinance is the provision of small-scale financial services to low-income individuals or low-income communities, small-scale meaning that the average outstanding balance of microfinance products does not exceed 250 percent of the averaging income per person (GNI per capita). Microfinance entails the supply of one or more of its principal components: credit, savings, insurance and money transfer. The services are supplied by a microfinance institution that is either regulated or non-regulated. (Robinson 2001, 9–10; The Mix 2010)*

Whether this definition is sufficient for the purpose of this research project, will be discussed in Chapter 6.

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[18] As in the definition of The Mix it is not the loan amount serving as a litmus test to evaluate whether some MFI is still operating in the microfinance sector. Rather it is the outstanding balance, meaning the aggregate of all outstanding financial services (e.g. fees, insurance premiums, loans) a microfinance client has at a specific moment in time.

[19] In literature, definitions accounting for a range of possible loan sizes instead of an outstanding balance that accounts for geographical regions are still common. For instance, Robinson refers to loans ranging from USD 10 to USD 10’000 (2001, 37) or La Torre and Vento (2006, 24) stating a range from USD 10 to USD 5’000. With the frame of reference provided by the Mix, microfinance loans disbursed in Tanzania, where we have an average income of USD 1’750 per person and year, could go up to USD 4’500 (GNI per capita figures are taken from the World Development Indicators, The World Bank 2014a). The Mix’s definition accounts for these country specific variances in income and is more accurate than the general ones by Robinson and La Torre and Vento.

5.2 Target Groups of Microfinance

Microfinance mainly targets two groups: own-account or self-employed workers, and women living at the BoP. Microfinance clients are normally own-account workers living at the BoP, wanting to get economically active. The International Labour Organization's (ILO) defines the term own-account worker as

> *a person who operates his or her own economic enterprise, or engages independently in a profession or trade, and hires no employees. (United Nations Statistical Office 1990, lit. b)*

Although microfinance clients work alone for the most part, they sometimes do have a few people they employ. Since microfinance clients cannot be ruled out to have employees, I use the term self-employed interchangeably with own-account worker. Self-employment jobs are defined as follows:

> *Self-employment jobs are those jobs where the remuneration is directly dependent upon the profits (or the potential for profits) derived from the goods and services produced (where own consumption is considered to be part of profits). The incumbents make the operational decisions affecting the enterprise, or delegate such decisions while retaining responsibility for the welfare of the enterprise. (ILO 1993, art. 7)*

Own-account or self-employed workers run microbusinesses, and might work as street vendors, seamstresses, hairdressers, or farmers.

Microfinance is further renowned for having a focus on women. Women constitute the majority of microfinance clients. Summarizing the latest numbers, which are from 2012, we look at the following figures of clients reached: The State of the Microfinance Summit Campaign Report indicates that 3'718 MFIs reported a total number of 203.5 million clients that had a current loan. Of these 203.5 million clients, 74.9 percent are women. Looking at the poorest clients reached, the total is 115.6 million, of which 83.3 percent are women (Reed 2014, table 1). In summary, there are five reasons why microfinance is mainly concentrating on women. These reasons can be categorized as being motivated from a business (I-III) or poverty alleviation perspective (IV-V).

I. The commercial financial sector in developing countries traditionally discriminates against women, which results in no access or difficulties in obtaining access to credit or other financial services (UNDP 2013, 5–6; Armendáriz and Morduch 2010, 212). Banks widely focus on male clients and back formal businesses. This translates into a negligence of women on the one hand and the informal sector where most of the world's poor try to make a living on the other hand. Women constitute 70 percent of the world's poor and microfinance takes advantage of that in almost exclusively providing financial services to women working in the informal economy (Bureau for Gender Equality and International Labour Office 2008, 2).

II. Research of the 1990s showed dramatic differences between men and women in regard to access to resources (e.g. rights and liberties, decision-power, access to money, social relationships, jobs), results revealed that women were the clear losers in contrast to their male counterparts. Women however have considerable potential, which they could invest into an income generating activity (Dobra 2011, 134–135). Neglecting informal businesses thus results in overlooking a big and increasing segment of potential female clients. MFIs therefore gain access to a large market.

III. Women simply report higher repayment rates in regard to borrowed money than men (Gibbons, Kasim, and Ikhtiar 1990; Khandker, Khalily, and Khan 1995).

IV. In contrast to their male counterparts, female borrowers invest a bigger share of their income into the household and family, including nutrition, education and health (Collins et al. 2011; Littlefield, Morduch, and Hashemi 2003, 1–2; Armendáriz and Morduch 2010, 5, 267–311; Hoddinott and Haddad 1995; Thomas 1990; Thomas 1994; Khandker 1998).

V. Granting women access to credit may reduce inequalities regarding gender and access to resources and might contribute to the overall improvement of the status of women in developing countries (Bureau for Gender Equality and International Labour Office 2008).

5.3 Microfinance Providers and Credit

The following chapters give a summary of microfinance providers and the core product of microfinance, which is credit. *Firstly*, different types of MFIs that offer a range of financial and sometimes also non-financial services are presented. *Secondly*, credit as the main service of microfinance is explained in more detail[20]. A strong focus is put on the principal-agent problems (i.e. adverse selection and moral hazard), arising when providing uncollateralized loans and it is discussed how MFIs manage these problems with specific lending methodologies.

5.3.1 Different Types of MFIs

Literature distinguishes between informal, semiformal and formal microfinance institutions. *Informal institutions*, for example private moneylenders, family and friends, Rotating Savings and Credit Associations (ROSCAs), constitute informal ways to purchase credit or save money and lack a legal status (Armendáriz and Morduch 2010, 67–68). In contrast, *semiformal MFIs* have to register their operations with an official authority. Which authority is responsible depends largely on the type of institution (e.g. unlicensed MFIs, NGO, post offices, financial cooperatives, credit unions) and country regulations. Semiformal institutions are subject to other „laws and regulations than banks and other formal institutions" (Isern, Donges, and Smith 2008, 115). In many countries, only financial institutions with a banking license may take deposits, hence most of the semiformal MFIs are credit-only institutions (Isern, Donges, and Smith

[20] Other microfinance products, such as savings, insurance, and money transfer products as well as the variety of investors that may be involved in funding MFIs' lending operations are summarized in appendix.

2008, 115). *Formal MFIs* are subject to the same laws and regulations as traditional banks. They are under the supervision of official authorities such as a financial market supervisory authority, a central bank and banking law in general. Formal MFIs may include microfinance oriented banks, agricultural banks, and regulated MFIs (Isern, Donges, and Smith 2008, 115).

5.3.2 Microfinance Products

Credit, savings, insurance and money transfer are counted among the core financial services a microfinance institution provides. Some MFIs also offer non-financial services such as training (e.g. financial literacy and health education programs), which is not considered amongst the main services of microfinance. MFIs offering training programs are normally referred to as doing 'microfinance plus'[21].

The following presents microfinance's most prominent product[22]: credit. As described in Chapter 4.1 providing the BoP with credit is complicated, since there is a lack of collateral and information about the riskiness of the borrower. Accounting for this lack, it is explained in more detail, what specific lending methodologies MFIs apply to mitigate information asymmetries in the absence of conventional forms of collateral. A detailed description of credit products serves the purpose of this research in such a way that the knowledge about why MFIs use particular lending techniques later on serves as a foundation to understand that specific lending methodologies alone might not prove to be sufficient to protect microfinance clients from over-indebtedness.

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[21] I provide a detailed description of a financial literacy program of such an institution in Chapter 18.1.

[22] The other services, such as savings, insurance and money transfer products are shortly discussed in the Appendix.

5.3.2.1 Credit

Microfinance's most common product is microcredit. It targets financially excluded individuals or communities by supplying them with loans. Whereas all MFIs provide credit, not all MFIs, as mentioned in Chapter 5.3.1, offer the whole spectrum of financial services. The loan amount disbursed must be relatively small (i.e. not more than 250% of the averaging income per person and year) and the loan maturity is normally below one year (La Torre and Vento 2006, 44). Repayment schedules usually foresee monthly or weekly installments (La Torre and Vento 2006, 24). As mentioned above, interest rates are usually higher than in collateralized banking. The average reaches about 35 percent but can range from 17 percent in Sri Lanka to 80 percent in Uzbekistan (Kneiding and Rosenberg 2008, 1). The purpose of credit is to give the client the opportunity to get economically active with the money received. Microloans traditionally are not intended for consumption needs (La Torre and Vento 2006, 43). However, clients sometimes also make use of credit products for unforeseen events or consumption (Gonzalez 2008, 100).

In Chapter 4.1, I touched upon the issue of agency problems in microfinance. The following chapter now explains how MFIs make use of group- or individual-based lending to set incentives to overcome imperfect information problems between the MFI and the client and as a consequence manage to decrease default risks.

5.3.2.1.1 How to Overcome the Problem of Asymmetric Information and Uncollateralized Credit

If we want to conceptualize the relationship between the MFI and a microfinance client as a principal-agent relationship, the MFI would be the principal delegating tasks (e.g. using the loan for the agreed upon entrepreneurial project) and the client would be the agent who has to deliver the tasks[23]. PA-relationships are characterized by the problem of

[23] Principals and agents are both equipped with their own utility functions (Drazen 2000, 23).

imperfect information. The agent, fulfilling the task, will always have more information about how accurate she is going to fulfill that task. Analogously, the microfinance client, although claiming to use a loan according to the agreed upon purpose, might not live up to this promise and will use the loan for something else (e.g. repairing the house, consumables). Situations of imperfect information between the MFI and its clients may cause inefficiencies like under- or overestimating the riskiness of a client and might even culminate in market failure (Akerlof 1970, 490). The specific problems arising from asymmetric information between a principal and an agent are *adverse selection* and *moral hazard*, which are explained in more detail in the following. How MFIs try to mitigate these asymmetries by the means of specific lending methodologies is presented when discussing particular group and individual lending techniques.

5.3.2.1.1.1 Adverse Selection

The most noticeable example of explaining adverse selection is „The Market for Lemons: Quality Uncertainty and the Market Mechanism" by George Arthur Akerlof (1970). Akerlof shows that the combination of diversity in quality and information asymmetries between the seller and buyer leads buyers to choose bad quality cars over good quality cars. As a consequence, good quality cars are squeezed out of the market.

What are the underlying considerations Akerlof makes to come to that conclusion? Whereas the seller of a used car knows exactly what kind of hidden characteristics (e.g. future repairs, defects) the respective car entails (Akerlof 1970, 489), the buyer faces the problem that a used car cannot be easily inspected and defects of a used car mostly stay undiscovered due to a lack of knowledge about cars in general or also due to a lack of time the buyer wants to invest into buying a car. Imagine a car park where different vendors want to sell used cars. A buyer walks up to vendor I. Although car I is of low quality, vendor I will describe this car as of high quality and well maintained. The buyer looks at a different car from vendor II. This model is actually a perfectly maintained used car without any defects. Vendor II explains proudly that he took good care of car II and that the buyer would not have to expect any repairs in the near future. The buyer is confused. Car I is USD 1000 cheaper than car II. Since he evaluates both offers as bona fide, he decides to buy the cheaper car. Akerlof transfers this situation to the big scale and shows that as a result of asymmetric information vendors will pass off their low-quality cars as higher-quality cars. After some time all of the vendor II types leave the market because they are not willing to sell off their cars to a price below their acceptance limit. In the end the buyer can only purchase 'lemons' (i.e. bad cars) for a relatively high price (Akerlof 1970, 489–491).

Analogously to the above-described, imperfect information between the MFI and its client prohibits the MFI from categorizing its clientele into riskier and safer borrowers[24]. Setting accurate incentives is key in order not to end up with a pool of clients that consists only or merely of risky clients. The traditional banking sector also faces similar problems; however, a bank would not face exorbitant losses if, for example, some of their clients would not be able to repay their loan. Why is that? Traditional banks only disburse collateralized loans. Borrowers can show securities, such as land, a house or a business, which may be seized by the bank if the loan is not repaid. It follows that, due to the collateral that is at stake, the borrower is incentivized to rather pay back the loan than to shirk. With a contractual agreement that is enforceable, the bank (i.e. principal) can effectively minimize its agency costs because losing the collateral is incentive enough to repay. No additional endeavors have to be undertaken in order to elicit a sufficient repayment behavior from the borrower. In contrast, MFIs have higher agency costs due to the uncollateralized loans they disburse. If there is no collateral to seize, the MFI has to create a system of incentives, which enhances the probability of the borrower to repay (Armendáriz and Morduch 2010, 41–48). Microfinance tries to create this system of incentives by means of group lending and costly individual lending schemes, which are discussed after the next chapter (Armendáriz and Morduch 2010, 101, 140).

[24] See also Akerlof's (1970, 498–499) analysis on India's informal credit market.

5.3.2.1.1.2 Moral Hazard

Besides adverse selection, two manifestations of moral hazard are prevalent in microfinance (Armendáriz and Morduch 2010, 39–53): ex ante and ex post moral hazard. The incertitude an MFI has about its client's actions after the loan is disbursed but before net returns on the entrepreneurial project are realized is explained by *ex ante moral hazard*. Due to insufficient information the MFI is in the dark regarding the borrower's undertakings. She might indicate putting the loan to the agreed upon cause; however, it is characteristically for PA relationships that the agent (i.e. borrower) in contrast to the principal (i.e. MFI) has the advantage of knowing her exact agenda. The lender is moreover not in power to entirely monitor the actions of the borrower. This would be too cost intensive.

After net returns on the entrepreneurial project are realized, MFIs face another incomplete information problem, which is called *ex post moral hazard*. It depicts situations where borrowers confirm to have failed in their business idea. In some cases it might not be straightforward whether a business project succeeded. As a consequence, lenders struggle to enforce contracts and face the risk of not being paid back. This is particularly difficult in developing countries with weak legal systems. As argued above, there is no or only negligible collateral to seize after a client has defaulted on her loan. If MFIs cannot elicit an adequate repayment behavior from their clients, they are confronted with losses.

5.3.2.1.1.3 *Group- and Individual Lending Methodologies*

MFIs strive for setting incentives that are cost-effective and socially acceptable. To minimize the number of risky clients, which are likely to default, microfinance may apply different means. To minimize the information asymmetries between MFIs and their clients, MFIs focus on the three main stages of a credit cycle. In order to enhance the repayment rate, MFIs screen their clients before they take out a loan, monitor them while they use the loan for an entrepreneurial project and enforce contracts, if clients are in arrear with payments. Enforcing contracts may include seizing collateral, if existing, naming and shaming or disqualifying clients from future credit (Van Bastelaer 2000, 12). Depending on the lending scheme applied, MFIs may set further incentives to repay. Below, group- and individual lending schemes in microfinance are discussed.

Group Lending

The history of group-based lending goes more than 150 years back in history. The 'People's Banks' in Germany was founded in the mid-nineteenth century by Frederik Raiffeisen. The difference between the „People's Banks" and today's group lending schemes in microfinance is only a small one. They both use joint liability and horizontal social capital, meaning that current group members evaluate potential members to join the group. They also both target poor people (Van Bastelaer 2000, 11)[25].

Today's MFIs that apply group lending let borrowers build groups of a minimum of three up to a maximum of forty people and supply them with credit (Armendáriz and Morduch 2010, 97). If a member is unable to pay, the group is jointly liable. If one or more group members default, the others have to come up for the outstanding sum. In this way joint liability represents the collateral (Natarajan 2004, 3). Joint liability insures the MFI

[25] Another form of group-based lending that existed long before there was microfinance is ROSCAs. They constitute peer-to-peer banking and lending in the informal sector. After deciding on a certain amount of money, each ROSCA member, for example, puts USD 7 into a pot every month. Starting from the assumption that there are 10 people. Hence, every month there is a pot of USD 70. The group decides who will get the lump sum of USD 70 first. This process is repeated until every member of the group has been able to receive the USD 70 to invest.

against individual risks, though this does not prevent group members from free riding. „[L]ow quality clients can free-ride on high quality clients leading to an increase in default rates" (Cason, Gangadharan, and Maitra 2012, 207). In order to mitigate adverse selection problems, MFIs use horizontal social capital in order to give group members incentives not to default. MFIs let the clients form their groups themselves. Self-selection implies a certain level of trust and like-mindedness among group members, also they probably have a similar economic standing (Van Bastelaer 2000, 13). These processes serve as client screening at a very low cost. To mitigate ex ante and ex post moral hazard MFIs make use of the superior knowledge group members have about each other in comparison to outsiders, such as loan officers (Cason, Gangadharan, and Maitra 2012, 193). The group executes the monitoring while business projects are launched and after. The main incentive to monitor group members is certainly joint liability. They know that if a member of the group defaults all are liable to repay the outstanding sum. Also social sanctions might mitigate moral hazard problems. If group members face the risk of being excluded from the group or named and shamed in the community, they might not default. These are all incentives to mitigate the risk of defaults among group members (Armendáriz and Morduch 2010, 125–127).

Characteristically, the group-lending scheme is defined as the MFI shifting the screening, monitoring and enforcing costs onto the group. But also the MFI itself has options to help enforce group loan contracts. *First*, the MFI might ask for compulsory savings, which it can take if a group member defaults (Morduch 1999, 1585). *Second*, the group's access to future loans might be denied in case of default (Morduch 1999, 1582). However, Rai and Sjöström (2004; see also Van Bastelaer 2000, 17–18) show that group lending contracts are rarely strictly enforced. MFIs will probably face smaller losses when they are open to renegotiating the terms of the loans. Furthermore, it is important information whether a loan was not repaid due to insufficient effort by the borrower or because the borrower was ill, suffered a death in the family or had a bad harvest. In these cases, Rai and Sjöström (2004) suggest using cross-reporting (i.e.

talking to neighbors and friends about what happened) in order to verify the story of the defaulting group member. In sum, group lending is a relatively cost-effective scheme unless loan terms have to be renegotiated. In that case administrative, monitoring, adjustments costs rise and render group lending more expensive.

Individual Lending

Individual-based lending is related to lending in the conventional banking sector. It is imperative to screen and have a close contact with clients that are earning a low income in order to mitigate information asymmetries between the MFI and its clients. In contrast to group lending, the tasks of screening, monitoring and enforcing contracts remain with the MFI (Dellien et al. 2005, 2–3). *First*, screening a client's financial and livelihood situation (e.g. reputation in the community, credit history if available, existence of collateral, personal and business risk) is key in order to assess a client's creditworthiness (Dellien et al. 2005, 3). *Second*, monitoring is especially important to reduce moral hazard problems. Without closely monitoring the borrower, the credit might not be used for the agreed upon business project. „Gathering information from neighbors can be helpful at many stages in the loan process" (Armendáriz and Morduch 2010, 160–161). *Third*, in regard to the enforcement of contracts, individual lending, cannot rely on joint liability but draws on other options to provide the client with incentives to repay (Armendáriz and Morduch 2010, 137–162):

i. trustworthy and reciprocal relationship between the MFI and the borrower including periodical consultations with neighbors and friends to gather information
ii. co-signer as guarantor
iii. repayments in public
iv. prospects of future loans or/and to receive products at a reduced rate
v. alternative collateral that has no resale value for the MFI but is problematic to lose for a borrower (e.g. kitchen utensils, TV)

So, even if individual lending is very costly there are options how an MFI can self-insure against default.

The preceding chapters provided an overview of the functions, target groups, providers, products, and funders of microfinance. Furthermore, the current definition of microfinance was introduced. The current microfinance definition introduced in Chapter 5.1 gives an answer to the questions „Who is providing the financial services, and what are these services?”. In the following, this current definition is challenged and I argue an extension. Three arguments are advocated in order to extend the current definition of microfinance by a dimension demanding that microfinance is also defined by how the products are supplied. *First*, due to the fact that microfinance clients are vulnerable by default, microfinance providers should account for this fact when providing financial services to them. *Second*, microfinance has an inherent social mission. That is why microfinance providers should focus on supplying products, which are suitable for their clientele. *Third*, the far-reaching effects of over-indebtedness crises showed how microfinance clients and MFIs alike suffer from such crises MFIs should therefore protect their clients of over-indebtedness.

6 Extending the Definition of Microfinance

Definitions of microfinance mainly address the questions of „What is microfinance?", „What kind of products does microfinance entail?", „Who is the target group?", „Who provides microfinance services?". In Chapter 5.1, I introduced a common definition, which includes the who- and what-dimension of microfinance.

> *Microfinance is the provision of small-scale financial services to low-income individuals or low-income communities, small-scale meaning that the average outstanding balance of microfinance products does not exceed 250 percent of the averaging income per person (GNI per capita). Microfinance entails the supply of one or more of its principal components: credit, savings, insurance and money transfer [what-dimension]. The services are supplied by a microfinance institution that is either regulated or non-regulated [who-dimension]. (Robinson 2001, 9–10; The Mix 2010)*

However, against the backdrop of the vulnerability of microfinance clients, the inherent social mission of microfinance and recent events in a few microfinance markets, there is reason to add a 'how-dimension' – or as I also interchangeably refer to it the 'quality-dimension' – to a definition of microfinance. Hence, a definition of microfinance should, as I claim, also give an answer to the question of how microfinance services should be provided.

Including a how-dimension into a definition of microfinance is, to the best of my knowledge, a novel idea. So far, there is no definition that includes how microfinance services should be provided to its beneficiaries. However, the indication that MFIs should provide their clients with products, which have a certain quality, is not a recent one. Muhammad Yunus emphasized the necessity of „specialized delivery mechanisms" in order to reach poor households in the 1990s (Yunus 1992d, 86). He argued that the appropriate quality of credit institutions and services is a prerequisite to meet the needs of a poor client (Yunus 1992a, 75; Yunus 1992c, 58; Yunus 1992b, 78).

> *[T]he poor will be effectively reached if the programs [poverty focused programs such as MFIs, S.L.] are designed exclusively for the poor, implemented through specialized delivery mechanisms with specialized people, designed by people who know what they are doing and for whom. (Yunus 1992d, 78)*

He underlines the importance of how financial services are supplied. MFIs „require specialized people starting from the planning and designing level down to the person-to-person contact in the field" (Yunus 1992d, 86). More recently, CGAP, although not including it into their definition of microfinance („microfinance is the provision of financial services to low-income people") at least makes the connection between the need of low-income communities to gain access to a broad range of financial services with the endeavors of the global financial inclusion agenda that „recognizes the importance of financial literacy, building consumer financial capabilities, and […] consumer protection policies that take the conditions and constraints of poor families in the informal economy into account" (CGAP 2014). McKee, Lahaye, and Koning (2011) make a similar connection and state that responsible finance, which among other factors includes client protection, should be the new standard for the supply of financial services to the BoP. Also the SPTF, which is a membership organization encouraging that MFIs and other stakeholders in microfinance abide by certain standards when doing business with vulnerable clients, emphasizes the moral obligation financial institutions have to protect their clients from harm (Social Performance Task Force 2016c). Presuming microfinance's clients' vulnerability, the inherent social mission of microfinance, and recent over-indebtedness crises, I claim that the connection between microfinance and the protection of its clients is a much more direct one. The connection is of such a nature that I argue to extend the microfinance definition by a quality-dimension, which accounts for how microfinance products should be supplied to the BoP.

In the following, three arguments are provided why standards governing how microfinance services should be provide to low- and zero-income clients should be included into the current definition of microfinance.

6.1 The Vulnerability of Microfinance Clients

The first argument is that microfinance clients are vulnerable by default. Microfinance clients are characterized by being more vulnerable to risks than people having a higher standard of living and income. People living at the BoP are highly vulnerable to outer shocks, such as natural catastrophes or illnesses. The term vulnerability is distinct from the superseded one-dimensional definition of poverty which focuses exclusively on income as an indicator for poverty. Vulnerability as it is understood here can be subsumed under the, now widely accepted, multi-dimensional definition of poverty. The multidimensional understanding of poverty presupposes „different dimensions of deprivations" which concern the lack of economic, human, political, protective, and socio-cultural capabilities (OECD 2001, 37). Vulnerability could be therefore subsumed under the lack of protective capabilities as presented in the DAC Guidelines for Poverty Reduction (OECD 2001, 38). Chambers defines vulnerability as follows:

> *[Vulnerability] means […] defenselessness, insecurity, and exposure to risk, shocks and stress. Vulnerability here refers to exposure to contingencies and stress, and difficulty in coping with them. Vulnerability has thus two sides: an external side of risks, shocks, and stress to which an individual or household is subject; and an internal side which is defenselessness, meaning a lack of means to cope without damaging loss. Loss can take many forms becoming or being physically weaker, economically impoverished, socially dependent, humiliated or psychologically harmed. (Chambers 1989, 1)*

Microfinance clients in particular are affected by the vulnerability context and are prone to unexpected adverse shocks mainly because of their own-account worker or self-employed status (Rakodi 2002, 120; Lombard 2006, 242).

Figure 1 illustrates how microfinance products may be used alone or in combination with others to account for certain events in a household life cycle. The life events that are featured in the figure are situations that every individual encounters with certainty, or is probable to encounter in her life.

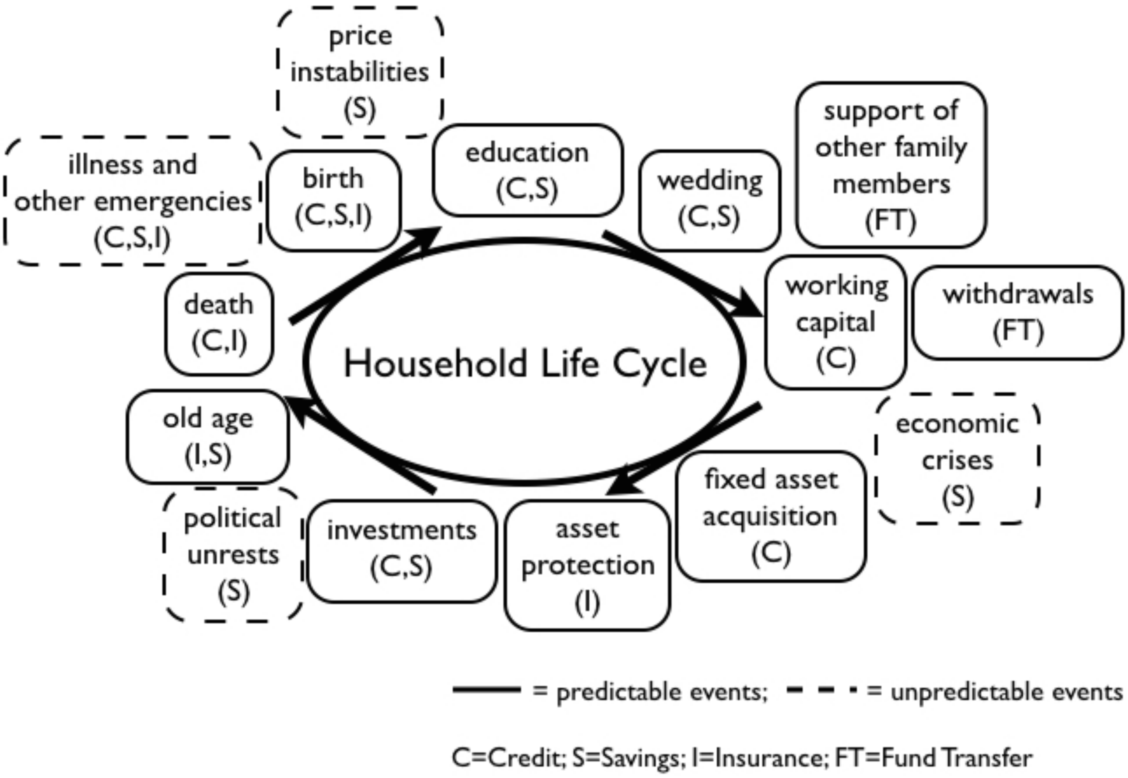

Figure 1: Financial Needs in a Household Life Cycle (adapted from Landolt 2009, 15)

Evidently, we all face many and diverse risks over our life span. Yet, for people living at the BoP seemingly normal life events have a far more serious impact than they have on people living above a certain income level. Besides providing a summary on which microfinance products match what kind of life events, this figure again underlines how vulnerable microfinance clients potentially are. The European Court of Justice (ECJ) substantiates that microfinance clients could be considered vulnerable clients in consideration of its rulings. Microfinance clients are not average clients or consumers. The concept of the average consumer or client (as I shall refer to her interchangeably) is regularly used in verdicts of the ECJ. The average consumer is defined as „reasonably well informed and reasonably observant and circumspect"[26]. In its judicial decisions the ECJ however also refers to vulnerable consumers. The vulnerable consumer does, in particular purchasing situations, need a more intense level of protection relative to other consumers (Benöhr 2013, 17, 22, 23; Cartwright 2011, 7–8)[27].

Although literature does not discuss the dichotomy between the average and vulnerable consumer in connection with microfinance it is worthwhile to elaborate whether these concepts prove fruitful in advocating a revision of the current microfinance definition. I argue that the microfinance client is not an average client but a vulnerable client by default. This means that microfinance clients, due to their marginal economic and livelihood situation, should be always considered vulnerable and therefore all should receive „a higher level of protection" (Benöhr 2013, 17). This protection could not only be provided by the state and therefore by means of regulations and other protective policies (e.g. credit bureaus, consumer protection acts) but also by MFIs, and many of them already do, as I show in Part III of this research project, that apply best practices that safeguard at least a certain level of client protection. Assuming that microfinance clients are vulnerable clients, has certain implications for how microfinance clients should be provided with financial services. Furthermore, the definition of microfinance should account for this vulnerability and therefore include a quality-dimension, meaning that the definition of microfinance should also account for how microfinance products should be supplied.

[26] Case C-210/96 Gut Springenheide and Tusky [1998] ECR I-4657, para 31. Online: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:61996CJ0210&from=EN [last accessed 25.04.2016].

[27] Case C-382/87, Buet v Ministh·e Public [1989] ECR 1235, para. 13. Online: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:61987CJ0382&from=EN [last accessed 25.04.2016].

6.2 The Social Mission Inherent to Microfinance

The second argument for including the demand for enhanced protection into the current definition of microfinance is the social mission that the microfinance business model bears. Traditionally, it is in the social mission of MFIs to lift people out of poverty, or at least to help them smooth fluctuations in consumption and to better manage their money through giving them access to financial services. MFIs by definition lend and provide financial services to low- or zero-income clients and aim to better their livelihood situations. They know about their capabilities and they are aware of problems among their potential client base such as vulnerability against unexpected shocks or vulnerability due to illiteracy, and specifically financial illiteracy. Owing to the social mission inherent in microfinance, MFIs should apply certain measures to compensate for this fact and, for example, be transparent regarding their prices and fees, inform their clients about the terms of the contract, refrain from aggressive lending methods and the like.

6.3 Over-Indebtedness Crises

The third argument for incorporating the demand for client protection into the current definition of microfinance are late over-indebtedness crises. Microfinance markets in Bolivia (1998-1999), Colombia (1999-2000), South Africa (1999-2002), Morocco (early 2008), Bosnia and Herzegovina (2008), Pakistan (late 2008), Nicaragua (2009-2010), India (2010) and Chile (2010-2011) underwent repayment crises and were seriously shaken or collapsed entirely (Chen, Rasmussen, and Reille 2010, 1; Davel 2013, 12). The exact reasons for microfinance crises may be manifold and not clear-cut but aggressive commercialization of the sector combined with abusive lending practices, concentrated market competition, political interferences and non-repayment movements played a vital role.

Due to these crises academics as well as individuals and groups of the private and public sector started to evaluate the assets and drawbacks of microfinance more critically. In addition, they have recently started to analyze the adverse effects the provision of microfinance could have, especially debated is the problem of over-indebtedness among borrowers, and what promising ways there are to minimize the probability of facing such over-indebtedness crises again soon[28]. There is common ground among the advocates of microfinance that there should be enhanced protection for microfinance clients and that practices such as aggressive lending or misleading advertising harm clients and should not be part of microfinance and that MFIs should make their contribution to mitigate the risks of over-indebtedness among microfinance clients (Schicks 2011a; Schicks 2011b; Schicks 2012; Schicks 2010; Chien 2012; Brix and McKee 2010).

7 The Extended Definition of Microfinance: Adding a How-Dimension

I have argued that due to the vulnerability of microfinance clients, the inherent social mission of MFIs, and as a reaction to recent over-indebtedness crises that have left many microfinance clients in desperate financial situations there should be a rethinking of what microfinance defines. Microfinance should not give leeway for misleading practices and should not be considered microfinance unless some quality standards are met by MFIs. Including a quality-dimension into the definition of microfinance creates a general understanding that microfinance ought to be carried out within certain boundaries. What these boundaries are and what we reasonably can demand from MFIs are still up for discussion and is further addressed throughout this research endeavor. Microfinance should not only be defined by who provides the services, who receives the services and what these services are but also how the services should be provided. I therefore propose to add an extension to the current definition of microfinance, which includes standards of client protection. The revised definition of microfinance reads as follows:

[28] I elaborate more on over-indebtedness, its causes, consequences and possible solutions for mitigation in Part II of this research project.

Microfinance is the provision of small-scale financial services to low-income individuals or low-income communities, small-scale meaning that the average outstanding balance of microfinance products does not exceed 250 percent of the averaging income per person (GNI per capita). Microfinance entails the supply of one or more of its principal components: credit, savings, insurance and money transfer [what-dimension]. The services are supplied by a microfinance institution that is either regulated or non-regulated [who-dimension]. Regarding the provision of its services, the microfinance institution complies with client protection standards, and therefore refrains from harmful practices [how-dimension/quality-dimension].

8 Conclusion

Microfinance aims to bring financial services to the BoP and bears the potential to benefit its clients in various aspects and eventually enable them to escape poverty. Besides having a double bottom line, the business model of microfinance is yet in another way distinct from traditional banking business models, due to the fact that MFIs provide uncollateralized loans while having to deal with the same asymmetric information problems underlying every loan contract. Providing credit but having no securities in case of default forced MFIs to take advantage of specific group- and individual lending methodologies. They help MFIs to prevent their clients from defaulting. Accounting for the additional risk of supplying uncollateralized loans, MFIs have to very closely screen and monitor their clients in the case of individual lending, and apply self-selection and joint liability in the case of group lending.

The promise of the 1980s and 1990s that the microfinance business model is one of the most beneficial poverty reduction instruments however revealed itself, at least partly, as unfulfilled; recent over-indebtedness crises are a proof of that. Due to unprecedented growth of the microfinance sector in many markets in the 1990s, MFIs eased their lending practices and clients took on more debt than they could manage. The failed promise of microfinance and experience of how clients suffered from having too much debt gave rise to scholars and practitioners alike to call for enhanced protection of clients. In Part I of this study, I account for this call and elaborate on the question whether the protection of microfinance clients is so substantial that extending the current definition of microfinance becomes necessary.

Arguing that due to the vulnerability of clients, the social mission that is inherent in microfinance, and as a reaction to over-indebtedness crises, there is reason to extend the current definition of microfinance by a quality-dimension was the main target of the first part of this research project. I claimed that the adherence of MFIs to certain client protection standards while supplying financial products is a fundamental feature of microfinance.

Therefore, the revised definition should not only consider what kind of products microfinance entails, who the target group is and who provides the services but also how the services are provided. Suggesting that microfinance products should be provided in accordance with client protection standards, I set a preliminary benchmark against how the quality-dimension could be evaluated. If such an extended definition proves helpful for practitioners and scholars is yet unclear. At the minimum, it serves as a normative demand that microfinance should aim to include certain standards of client protection and therefore abstain from practices that are potentially harmful to clients.

In Part II further implications of the extended definition of microfinance are elaborated. Starting from the assumption that the reason microfinance clients struggle with too much debt cannot be solely accounted for by the malpractices of MFIs, a detailed analysis of the causes and consequences of over-indebtedness not only on the MFI, but also on the client and market level, helps to assess whether including the how-dimension into the definition of microfinance lastingly protects clients from the risk of unmanageable debt or if there is need for a more comprehensive protective framework. I conclude that to protect microfinance clients effectively from over-indebtedness, it is not sufficient to extend the current definition of microfinance. Analyzing the causes and consequences of over-indebtedness in Part II suggests working towards and conceptualizing a broader framework, which includes all relevant microfinance stakeholders and calls upon them to take the responsibility necessary when doing business with the BoP (see part III).

Part II – Over-Indebtedness as the Core Problem of Microfinance

9 Over-Indebtedness and Microfinance

As discussed in Part I, MFIs use specific lending methodologies to minimize the information asymmetries between them and their clients. Applying lending strategies to reduce information asymmetries principally serves a business purpose, namely to increase the probability of the MFI being repaid. However, the debt situation of the borrower at the moment of repayment remains unclear. If the borrower has just fully repaid her outstanding loan with a loan from another financial institution, is irrelevant and often unnoticeable to the MFI. Yet, the borrower might be at the edge of being over-indebted. Such dynamics, meaning having no information about clients' real financial situations and lacking collateral to seize in case of default, can lead to MFIs' portfolios being increasingly at risk, which in turn might peak in entire markets losing stability. The main concern of Part II of this research project is to analyze the many causes of over-indebtedness and demonstrate its devastating and far-reaching consequences that materialized during late microfinance crises and to find approaches to minimize these effects. Over-indebtedness does not only impact the social and economic well-being of microfinance clients but may also greatly influence the systemic stability of microfinance markets and the financial sustainability of MFIs (Guérin, Morvant-Roux, and Villarreal 2014; Brix and McKee 2010; Schicks 2010; Schicks 2011b; Schicks 2012; Kappel, Krauss, and Lontzek 2010; Johnson 2014; Hummel 2014; Guérin 2013; Guérin et al. 2014; Schicks and Rosenberg 2011; Wampfler, Bouquet, and Ralison 2014). So what approaches are suited to mitigate over-indebtedness among microfinance clients?

In order to do so, the causes and consequences of over-indebtedness on all three levels are analyzed. The results will reveal that there are mainly three approaches to tackle over-indebtedness: state regulation, financial literacy programs, and soft law standards. This analysis then serves as the basis to brainstorm about connecting the extended definition, which calls upon MFIs to protect their clients from harmful practices, to a more encompassing framework including tangible strategies to tackle over-indebtedness (see Part III and Part IV).

The structure of Part II is as follows: To show how over-indebtedness may arise, I start at the root of the problem, namely by discussing that money is fungible after entering a household in Chapter 9.1. Again emphasizing problems of asymmetrical information inherent to loan contracts, I introduce how being in debt and having debt stress can lead to over-indebtedness.

The term over-indebtedness is defined in Chapter 10 and followed by a detailed analysis of the causes and consequences of over-indebtedness. This analysis is grounded on theoretical considerations and empirical data, and evaluates the client, institutional and systemic level.

The overall aims of Part II are to show that the causes of over-indebtedness are not only manifold and the consequences far-reaching and not restrictive to the individuals, but are also having a great impact on MFIs and microfinance markets. At the end of Part II and arising as a result from the over-indebtedness analysis, I detect that client protection is a prerequisite to prevent clients from being prone to debt stress or in the worst-case to over-indebtedness and suggest, in line with literature, three approaches to mitigate these risks from three different angles.

9.1 The Fungibility of Money

Part I of this thesis outlined how microfinance products are supplied, what their main characteristics are and which products are suitable for what life situations. Often the money goes to its stipulated purpose (e.g. business). However, clients sometimes also use credit products for unforeseen events (e.g. illness, droughts) or consumption (Gonzalez 2008, 100). The fungibility of money after the client has received the loan is the main focus in the discussion about debt management (Dunn 2004, 173). On the client side, it is crucial to the borrower to keep track of her financial situation to successfully manage her debt. On the provider side, it is essential to have information about how the client's financial situation develops over the repayment period in order to avoid defaults. As described above, the lender always lacks information about the borrower's intentions and plans she has with the loaned money. There are strategies (e.g. group lending with joint liability or individual lending with very close screening and monitoring) to reduce this information gap. Yet, the perspective taken in Chapter 5.3.2.1.1 focuses on the business aspect of microfinance. It answers the question: How can the MFI elicit a certain repayment behavior from its clients to prevent default? However, a client that repays her loan does not necessarily stand for a client without any other debt. The assumption that money is fungible as soon as it enters a household implies that the money might be used for a business purpose, consumables, as emergency money or repayment of another loan. Figure 2 below illustrates these different possibilities.

After having received the money, the MFI cannot – at least not easily – detect whether a client uses the funds for the stipulated purpose or manages her debt well, is in debt stress or is already over-indebted[29]. These characteristics are hidden within a black box. How a client is able to manage her debt is influenced by different conditions. Debt management is for example affected by foreseeable and unforeseeable expenditures (e.g.

[29] A definition of debt stress and over-indebtedness is given in Chapter 9.2 and 10.

paying for daughter's wedding, expanding business, having to pay for medication).

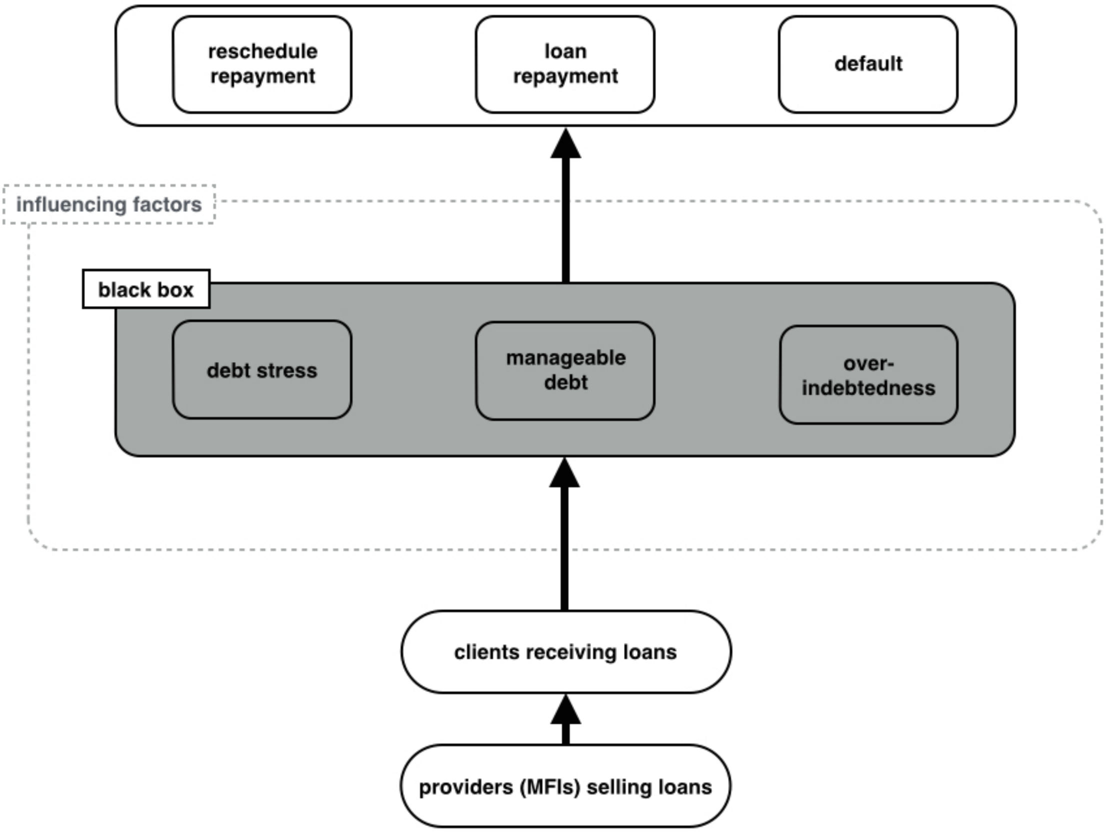

Figure 2: Within the Black Box – Manageable Debt, Debt Stress, Over-Indebtedness (O-I) (own figure)

As I show in the following, there are also other reasons besides unforeseeable and foreseeable events that define whether debt is manageable thus leading to full repayment, stressful thus leading to rescheduling repayment, or unbearable thus leading to default. To acquire a more complete picture of how over-indebtedness emerges, I firstly distinguish between the terms 'indebtedness' and 'debt stress', and secondly define 'over-indebtedness' followed by a detailed analysis of the causes and consequences of over-indebtedness on the individual, institutional and systemic level and its implications.

9.2 Indebtedness and Debt Stress

Being in debt is a common situation in our lives. Either we bought a house with a mortgage or we took a loan to start a business, or a friend lent us some money to buy lunch because we did not have any cash on us. Hence, being in debt seems to be normal. However, if we start to struggle to repay our mortgage, it makes us feel uncomfortable and pressured. We think about how to repay the money. Maybe we have lost our job or have been unsuccessful with our business idea or something else unexpected has happened. No matter what, we still have to repay. At this moment we enter into a phase of debt stress. Debt stress characterizes a state where a borrower finds herself in a debt-related crunch (Davel 2013, 1). If we are lucky, we find a new job or the business idea eventually takes off, and we are able to make all the installments. What if we do not find a way to repay the loaned money with our own resources? We start looking for other ways, let them be formal or informal. If we manage to receive money that is given to us with no hope of a return, our debt will no longer be of any concern to us. However, most of the time we find money that comes at a certain cost, namely interest. And even if we received it at zero interest, we still had to pay back the amount lent. According to Davel (2013, 1), debt stress paves the road to over-indebtedness.

10 Over-Indebtedness

In literature, there is no comprehensive definition of over-indebtedness in the realm of microfinance. How to define over-indebtedness is often dependent on the perspective. Either scholars look at the problem of over-indebtedness from a lender's perspective or from the borrower's perspective. From a *lender's perspective*, clients are over-indebted when they lack the capacity „to repay all debts fully and on time" (Haas 2006, 3). Best known for representing a benchmark of over-indebtedness from a lender's perspective is the so-called portfolio at risk-value (PAR-value) and the default rates the MFI shows on the outstanding loans. MFIs showing high

PAR-values and high default rates in the accounting sheets, point to over-indebtedness among their clients. Albeit PAR-values and default rates are taken as an indicator for over-indebtedness, they fail to adequately mirror this phenomenon. Guérin (2013) shows that there are two manifestations of default: liquidity and strategic defaults. On the one hand liquidity defaults occur when clients are not able to repay their debt. The source of their responsibilities can be manifold. If clients find themselves in debt stress or are already chronically indebted, their source of debts are normally of formal and informal origins. Thus, they stem from pawnbrokers, private moneylenders, MFIs, family and friends. On the other hand strategic defaults arise when clients have the liquidity to repay but choose not to (2013, 78; Morvant-Roux et al. 2014, 310–311; Guérin 2013). There are three main explanations found by two recent surveys of Guérin, Kumar, and Agier, conducted in Tamil Nadu (India), and Morvant-Roux, conducted in Morocco.

First, lenders in Tamil Nadu – either informal or formal – trust in local 'leaders' regarding the credit risk management of potential clients. These leaders are normally chosen due to their charisma, power to mobilize people and their knowledge of their community (Guérin, Kumar, and Agier 2013, S78; Guérin 2013). To let them manage the microcredit risk of potential clients led to fast client growth but simultaneously beard immense risks. This system of reliance can crash easily due to credibility loss or also when a key individual announces that borrowers do not need to repay their outstanding loans anymore (Guérin 2013)[30].

Second, Morvant-Roux et al. (2014, 310–311) state that clients may refuse to repay due to a „lack of legitimacy of microcredit providers". This points to the problem that without close social ties between the lender and borrower, loans are less probable to be paid back. That close ties and the „[c]ontinuity of a relationship creates an atmosphere of trust" was already

[30] A similar case occurred in Nicaragua, where Omar Gonzalez Vilchez, mayor of the northern municipality Jalapa called upon microfinance clients to not repay their loans anymore. The Movimiento No Pago was born. The borrowers believed that microfinance providers allegedly dragged them into debt owed to excessive interest rates and non-transparent information. A severe non-repayment crisis was the result (Minchev 2014, 2).

emphasized by Yunus in the 1990s (1992d, 88) and the hypothesis that the close relationship between local loan officers and borrowers positively influences repayment behavior is backed by several current studies (Karlan and Appel 2012, 52, 130; Morvant-Roux et al. 2014, 309; Collins et al. 2011, 208).

Third, if consequences of default are perceived to be marginal, borrowers will tend to default. In Morocco, state-owned providers disburse a lot of credit. Borrowers that perceive the Maghzen (Central Moroccan State Authority) as illegitimate take out loans and deliberately default (Morvant-Roux et al. 2014, 308). The empirical evidence of strategic defaults discussed above, suggests that numerical indicators do not capture over-indebtedness adequately. PAR-values and default rates are rough estimates and help to identify and assess institutional risks of MFIs or systemic risks of microfinance markets. However, they do not operationalize over-indebtedness effectively. These measures only reflect a snapshot in time and do not live up to giving a complete picture of clients' repayment situations. That is why this research project adopts an understanding of over-indebtedness, which represents the *client's perspective* and is oriented towards the definitions brought forward by Schicks (2010, 6), Kappel, Krauss, and Lontzek (2010, 7) and Gonzalez (2008, 100).

As argued in Chapter 6.1, risk is a constant companion when living at the BoP. Adverse shocks may destroy returns that would have been ascribed to other purposes. Instead of repaying debt, expanding the business or paying for school fees, the money has to be used to repair the house, buy medication or pay for a funeral. The future is uncertain, for all of us, however as argued before, this uncertainty especially affects the BoP. Risks, such as adverse and unexpected income shocks, are a key topic in an environment where incomes are low and volatile. Gonzalez (2008, 99–105) shows mathematically that a household, unless it defaults on the loan, has to undertake unduly high sacrifices to repay if hit by an external shock. Assuming uncertainty about the future means that households have no other choice than to make decisions on the bases of incomplete information. If the newly started business does not kick-off due to a currently bad economy, or if a household loses its most effective manpower due to an illness, a household may quickly face a decline in profit and assets in general. This leaves the household with two options, to default on the loan and thereby risking being denied a consecutive loan or to undergo unduly high sacrifices. Making unduly high sacrifices could mean the further destruction of other assets such as savings or cutting down on consumption or increasing effort (Gonzalez 2008, 100). Gonzalez' (2008, 99–105) mathematical models of repayment scenarios (i.e. making unduly high sacrifices to repay or to default and lose the possibility of getting another loan with the same MFI) have little in common with the static definition of over-indebtedness from a lender's perspective focusing on PAR-values.

The debt situation of a client is often multidimensional and much more complex than a single value manages to capture. Based on this argumentation, I adopt a client-centered definition of over-indebtedness, which follows Gonzalez (2008, 100), Schicks (2010, 6) and Kappel, Krauss, and Lontzek (2010, 7):

> *A microfinance customer is over-indebted if she is continuously struggling to meet repayment deadlines and repeatedly has to make unduly high sacrifices to meet her loan obligations. (Schicks 2010, 6)*

What causes microfinance clients to get over-indebted and how far-reaching the consequences of over-indebtedness are for the clients, the MFIs, and the microfinance markets is addressed in the following chapter.

10.1 Over-Indebtedness: Causes and Consequences

This chapter addresses the causes and consequences of over-indebtedness on the systemic, institutional and individual level. Ensuing from these reflections, seven hypotheses (H1-H7) and seven implications (I1-I7) summarizing the analysis of the causes and consequences of over-indebtedness are derived. As a result of the analysis three suitable approaches to mitigate the risk of over-indebtedness, which encompass consumer protection regulations, soft law standards and financial literacy programs are presented. I conclude with stressing the substantial role the protection of clients from over-indebtedness takes in microfinance and seize on the idea to connect the extended definition of microfinance with the more comprehensive and multi-stakeholder oriented framework of responsible microfinance, which I construe in Part III and IV of this research endeavor.

As mentioned above, several microfinance markets have experienced over-indebtedness crises and several studies have been conducted in order to learn more about the causes and consequences of over-indebtedness. With the focus on portfolio growth in the 1990s, literature and practice has not paid much attention to the great problem over-indebtedness poses to clients, as well as to MFIs and microfinance markets. Only recently, scholars, practitioners and policy makers have started thinking about the causes, consequences and remedies of over-indebtedness.

The microfinance over-indebtedness literature can be generously divided into two bodies of literature. The *first body of literature* argues that over-indebtedness in microfinance is caused by external, institutional, systemic and individual factors. Most of the literature is concerned with possible institutional and systemic factors that beget over-indebtedness (Cull, Demirgüç-Kunt, and Morduch 2009; Banerjee and Mullainathan 2010; Hulme 2000; Porteous 2009; DeVaney 2006; Schicks 2010; Schicks and Rosenberg 2011; Kappel, Krauss, and Lontzek 2010; Chen, Rasmussen, and Reille 2010; Davel 2013). Also there is a range of literature, which addresses the question of how external factors, such as political unrest, illness and natural catastrophe, add to over-indebtedness (Schicks 2010; Rakodi 2002). In contrast, only very few microfinance scholars are concerned with the causes of over-indebtedness on the individual level (in the broadest sense Gonzalez 2008). Therefore, I have to resort to studies focusing on the question of how borrowers can contribute to their own over-indebtedness, but which were mostly carried out in industrialized countries (Barr, Mullainathan, and Shafir 2009; Sprenger and Meier 2012; Campbell 2006; Bertrand, Mullainathan, and Shafir 2004; Anderloni and Vandone 2008). Nevertheless, I try to transfer and adapt these insights to the microfinance context. The *second body of literature* is concentrating on the consequences over-indebtedness has on the institutional, systemic and individual level. Thereby, most of the literature is concerned with the consequences over-indebtedness has on the individual borrower (A. Gonzalez 2008; Schicks 2010; McIntyre 2013; Hulme 2000; Sweet et al. 2013; Webley and Nyhus 2001; Wampfler, Bouquet, and Ralison 2014; Johnson 2014; Guérin et al. 2014; Hummel 2014; Schicks and Rosenberg 2011; Schicks 2012; Angulo Salazar 2014) and a smaller portion addresses the consequences on the financial institutions (Rosenberg 1999; Stearns 1991; Schicks 2010; Feasley 2011; Schicks 2011a) and microfinance markets (Kappel, Krauss, and Lontzek 2010; Schicks 2011a). Schicks (2010; 2011a) is among the few authors who give a detailed analysis of how over-indebtedness affects all three levels of analysis (i.e. individual, institutional, systemic).

In the following, I work through the causes – external, institutional, systemic and individual – and consequences – institutional, systemic and individual – of over-indebtedness. Please take into account that I cannot for all cases provide unambiguous boundaries between the levels of analysis. Especially between the institutional and systemic level, clear-cut lines cannot always be drawn. In order to derive implications and present tangible strategies to mitigate the risks of over-indebtedness at the end of this second part, I provide a comprehensive analysis of the literature and empirical findings on the causes and consequences of over-indebtedness on the individual, institutional and systemic level in the next chapters.

10.1.1 Causes of Over-Indebtedness

As in Schicks (2010), the causes of over-indebtedness are analyzed from three different viewpoints: external factors, institutional and systemic, and client-centered. Over-indebtedness might be triggered by external factors, provoked by particular actions and methods used by MFIs or generated by the actions of the clients themselves.

10.1.1.1 Causes: External Factors

In Chapter 6.1, I applied the vulnerability definition of Chambers[31]. Chambers thereby speaks of the two sides of vulnerability: external and internal. Taking account of the external side, poor people are highly susceptible to „risks, shocks, and stress" (Chambers 1989, 1). Microfinance clients in particular are affected by the vulnerability context and are prone to external shocks mainly due to their unsteady own-account worker or self-employment status (Rakodi 2002, 120; Lombard 2006, 242).

The nature of outer shocks can be manifold. Schicks (2010, 10) describes the following points as main factors in order for a client to move from debt which is easy to handle to unmanageable debt. *Personal tremors* such as illness, death of a family member, or failed business ideas may transform debt levels of microfinance clients from manageable to unbearable. *Political factors*, such as civil wars, riots and changes in governments may influence the debt management of clients. Clients may also face problems to repay successively if *climatic shocks* such as natural catastrophes occur. Furthermore, *economic dynamics* like price fluctuations but also the amount of informal alternatives borrowers have at their disposal affect their debt levels. The given *institutional* and *legal*

[31] „Vulnerability, though, is not the same as poverty. It means not lack or want, but defenselessness, insecurity, and exposure to risk, shocks and stress. Vulnerability here refers to exposure to contingencies and stress, and difficulty in coping with them. Vulnerability has thus two sides: an external side of risks, shocks, and stress to which an individual or household is subject; and an internal side which is defenselessness, meaning a lack of means to cope without damaging loss. Loss can take many forms becoming or being physically weaker, economically impoverished, socially dependent, humiliated or psychologically harmed" (Chambers 1989, 1).

frameworks have a great impact on the individual indebtedness levels via the MFI and regulations as well.

In the following the institutional and systemic reasons for increased over-indebtedness among borrowers are discussed.

10.1.1.2 Causes: Institutional and Systemic Perspective

Researchers (Schicks 2010; Schicks and Rosenberg 2011; Kappel, Krauss, and Lontzek 2010; Chen, Rasmussen, and Reille 2010; Davel 2013) assume that from an institutional and systemic perspective especially concentrated market situations but also aggressive commercialization and mismanagement of MFIs lead to over-indebtedness. There are three main hypotheses which can be found in literature:

I. Increased competition in and saturation of microfinance markets may lead to hazardous lending practices including aggressive marketing methods accompanied by changes in lending standards and procedures. This increases the risk of over-indebtedness.

II. Microfinance markets often lack an efficient system of pooled information about the credit record of microfinance clients. This may lead to higher over-indebtedness rates among clients, since MFIs cannot detect cross-borrowing and hence high-risk clients.

III. Inappropriate microfinance products may increase the risk of driving clients into over-indebtedness.

10.1.1.2.1 Competition in and Saturation of Microfinance Markets

Regarding the **first hypothesis** one can argue that several studies state that higher competition in microfinance markets alter lender behavior (Schicks and Rosenberg 2011; Chen, Rasmussen, and Reille 2010; McIntosh and Wydick 2005; Navajas, Conning, and Gonzalez-Vega 2003). Scholars assume that the nature of the microfinance market (saturation and competitiveness) and the way in which microcredit is provided (hazardous lending standards) result in a prevalence of over-indebted clients. In a saturated and competitive market situation it is key for MFIs not to lose any of their clients to competitors. In order to pursue this strategy MFIs keep their lending expenses on a low level. This might result in easing up the lending standards and reducing their client screenings (Schicks and Rosenberg 2011; Chen, Rasmussen, and Reille 2010; McIntosh and Wydick 2005). Refraining from or cutting back on techniques to assess the riskiness of clients has consequences. It has already been shown that even in a normal market situation, MFIs may lend almost exclusively to risky clients without knowing it. This phenomenon stems from asymmetric information problems (i.e. ex ante moral hazard and adverse selection). Imagine a saturated competitive market where MFIs cut back on all kinds of important screening techniques, the probability of choosing riskier borrowers over safer ones is expected to be even higher than in a less competitive market setting. Lending to risky borrowers results in higher default numbers and ultimately also increases the probability of clients cross-borrowing. In addition, MFIs apply aggressive marketing techniques in order to sell loans and show an „exaggerated focus on portfolio growth" (Schicks 2010, 9; see also Sinclair 2012, 45). In a microfinance-critical article Hulme (2000, 27) states that MFIs focus on portfolio growth and not, for example, on savings because savings in contrast to loan products are not profitable. Additionally, Hulme reports that in the case of Kenya Women's Finance Trust, clients who request to only make deposits and not to borrow will be „balanced out" (2000, 27). In other words: They are forced to leave the MFI. Banerjee and Mullainathan (2010, 36) are even more explicit. MFIs try to hinder clients making their way out of poverty. Hence, institutions are setting incentives that clients always re-borrow, even when they would like to cease taking up new loans or would like to pause their borrowing. This is because the MFI mainly earns profit through selling credit products and if clients stop taking out loans the business will be less profitable.

Scholars have also investigated the so-called „volume focused incentive system", which also negatively impacts the manner of selling loans (DeVaney 2006, 18). MFIs often pay performance-based salaries to their loan officers. Hence, the more loan contracts they sell, the higher their compensation is. The unprecedented growth the microfinance sector in many developing countries experienced also required hiring more, often inexperienced and untrained, loan officers. Such employees may make poor decisions on selling loan contracts and might more easily drive clients into debt stress and over-indebtedness than more experienced coworkers would (Schicks 2010, 10).

Furthermore, aggressive marketing strategies feature credit offers and advertising that are phrased and presented in a non-transparent and misleading manner (Porteous 2009, 7). Brix and McKee (2010, 4) emphasize that aggressive sales practices, such as „door-to-door solicitations or limited time-offers" might take advantage of clients' psychological biases (see also Chapter 10.1.1.3 on the client perspective). So, in addition to marketing techniques there are transparency issues regarding interest rates and terms of contracts (Brix and McKee 2010, 3). The less transparent the contract terms, the more prone the clients are to plunge into over-indebtedness. Being unaware of the terms of the contract, especially regarding very high interest rates and fees, contributes to borrowers' debt problems (Cull, Demirgüç-Kunt, and Morduch 2009; Collins et al. 2011).

Finally, some MFIs apply aggressive collection practices. As DeVaney (2006, 21) puts it, „a low default rate is critical to their [MFIs'] survival, institutions must put pressure on clients to repay". However, this does not legitimize aggressive collection practices, such as humiliation, intimidation or force (Schicks 2010, 11; DeVaney 2006, 21)[32]. Sinclair (2012, 203) finds very strong words for describing the results of the microfinance crisis in Andra Pradesh in 2010:

> *The subtle twist here, which was a novel development on the previous crises in Bosnia, Bolivia, Nicaragua, and even, debatably, Nigeria, was that in India the practices actually led to scores of suicides, occasional abductions, and some forced prostitution thrown in for good measure, to add a final veneer of respectability to the sector once and for all. […] but they [the MFIs] employed increasingly aggressive practices in the field to pressure clients to repay-until clients simply started killing themselves. Numbers vary on the number of microfinance related suicides, but the generally accepted number is fifty-four currently.*

These procedures „unduly increase the burden of indebtedness for borrowers" (Schicks 2010, 11). Furthermore, clients are often unaware of their rights and might perceive aggressive practices as standard (Schicks 2010, 11).

10.1.1.2.2 Lack of Pooled Information About Credit Records

The **second hypothesis** states that a lack of efficient pooled information systems leads to higher over-indebtedness rates among clients. Clients do in fact cross-borrow. That means they take out loans, either from informal or formal sources, in order to repay other loans. Microfinance knows roughly two solutions of how to detect cross-borrowing without increasing their expenses for screening potential clients more thoroughly: credit bureaus and informal sharing of credit information among MFIs[33]. Credit information systems serve the purpose of allowing MFIs to inspect information of their clients' credit histories. Scholars assume that if a microfinance market lacks such a system, clients are more prone to over-

[32] For further examples and cases of inappropriate collective practices see Tiwari et al. (2009).

[33] Informal data sharing systems come into play, when there is no credit bureau in place, or when MFIs without banking licenses are excluded and thus have no other possibility of gathering information (Brix and McKee 2010, 16).

indebtedness (Brix and McKee 2010, 15). What kind of information is collected however affects the usefulness of the pooled credit information system greatly and I explain the advantages and disadvantages of such systems in more detail in Chapter 17.2.

10.1.1.2.3 Inappropriate Microfinance Products

The **third hypothesis** describes the correlation between inappropriateness of microfinance products and over-indebtedness. Musoni, an MFI based in Kenya and other East African countries, interviewed its clients in regard to product design in general. Clients „value a product that they can access easily given their work schedule and their location, and a product that is flexible enough to fit their cash flows" (interview with an associate of Musoni in The Smart Campaign 2012, 2). Most of the investments and hence also repayment of loans is depending on seasonality (e.g. harvest period, raining season) (Schicks 2010, 10). MFIs need to take this fact into account and give out loans at times when it makes sense for clients and at the same time, have more flexible repayment schedules. For example, when cotton prices drop, clients should not have to sell under pressure and earn less because of that. In practice, flexible repayment schedules are seldom. Maturities are short and the repayment schedules can be rigid. Hence, clients with unstable revenues probably struggle to repay if they bought unsuitable credit products.

10.1.1.3 Causes: Client Level

This chapter focuses on microfinance clients and how psychological biases, cognitive biases, sociological influence and socio-demographic and economic factors may influence their successful debt management. *First*, the reasons for over-indebtedness stemming from psychological and cognitive biases are discussed. The neo-classical model of economics includes the assumption that actors are rational utility maximizers who have perfect information at their hands when taking decisions (Akerlof 1991, 1; Goodwin et al. 2015, 178, 183). Behavioral economics challenges this axiom. To do so, behavioral economists depend heavily on scientific experiments to provide insights about reasons for individuals behaving a certain way in situations. The core claim is that a more complex model of motivation than the one suggested by neo-classical theory is required to explain human behavior. Instead of rational actors, behavioral economists assume the actors' rationality to be bounded by cognitive biases, and the information accessible and the time available when making a decision (Goodwin et al. 2015, 184; Simon 1972, 163–164). *Second*, sociological influences that may impact debt management negatively are presented. *Third*, socio-demographic and economic factors influencing the debt management of microfinance clients are considered.

As I pointed out above, microfinance literature mainly addresses the external, institutional, and systemic perspective of the causes of over-indebtedness. Only a few microfinance scholars are concerned with the causes of over-indebtedness on the individual level (in the broadest sense Gonzalez 2008). Most of the studies referred to in this chapter have been carried out in industrialized countries (Barr, Mullainathan, and Shafir 2009; Sprenger and Meier 2012; Campbell 2006; Bertrand, Mullainathan, and Shafir 2004; Anderloni and Vandone 2008). Still I will try to transfer and adapt these insights to the microfinance context.

10.1.1.3.1 Psychological and Cognitive Biases

For the case of microfinance, behavioral economics tries to find explanations why a consumer would choose one product or service over another or why one client would default on a loan and the other would not. The microfinance and the U.S. mortgage crisis have shown again that the neo-classical model assuming rational agent behavior in competitive markets does not have to hold true after all. As discussed above individuals' decisions are limited by their cognitive capabilities, by existing information, and the time available in order to make a decision (Goodwin et al. 2015, 184; Simon 1972, 163–164).

First, studies show that client behavior is rather governed by their cognitive capabilities, their own ideas and impulses than by „deliberative intent" and „normative ideals" (Barr, Mullainathan, and Shafir 2009, 27). Studies show that clients lack self-control, are over-confident, and, or have inconsistent time preferences (Barr, Mullainathan, and Shafir 2009, 32; Schicks 2010, 12). Microfinance clients might, for example, be tempted by immediate consumption and assess a loans' benefits presently as more significant than its potential benefits in the future. But decisions a client makes grounded on her present utility function, are „unlikely to maximize long-term individual welfare" (Schicks 2010, 20). Behavioral economics has different explanations why individuals might act against their long-term well-being: the most prominent one being the 'hyperbolic discount function'[34]. Hyperbolic discounting assumes consumers have inconsistent preferences, which lead them to take decisions that negatively impact their long-term well-being. For example, last year I committed that at the beginning of this year I would start an ambitious savings plan in order to be able to buy a house in the future. But as this year was starting, I decided that I would start saving next year because I was not yet ready to undergo the consumption sacrifices that I would have to make to meet the goals of the savings plan (Laibson 1997, 445–446). Inconsistent time preferences

[34] Two other well-known approaches of behavioral economics to explain time inconsistencies are 'procrastination' (see Akerlof 1991) and 'dual self' (see Fudenberg and Levine 2006).

lead to the decision to postpone the savings plan yet for another year. Analogously, whether or whether not a client uses her loan for immediate consumption depends on the importance she ascribes to the immediate consumption in comparison to the potential long-term benefit of the loan. Hyperbolic discounting presumes that due to inconsistent preferences, consumers are motivated to „constrain their own future choices" (Laibson 1997, 443). Therefore, inconsistent time preferences may add to microfinance clients being prone to over-indebtedness.

Second, existing information greatly impacts the decision making of clients. An important source of decisions made by clients, which might lead to over-indebtedness, stems from asymmetric information. Only this time it is not the MFI lacking information about the client as with the problems of adverse selection and moral hazard but rather the client lacking information about the offerings of the MFI. Clients often lack information about microfinance products and their financial literacy in general is low (Schicks 2010, 12). Therefore, microfinance clients are likely to be susceptible to marketing and if financial products are presented in a misleading way, such as product prices being disclosed without additional fees, clients may buy products that exceed their financial limits.

Third, loans are sometimes needed on short notice and clients lack the time to compare offers of different MFIs. A study by Meier and Sprenger (2012) that was carried out in the U.S. showed that having an urgent need for a loan predicts creditworthiness. Hence, individuals that will wait for their loan will have a higher probability of paying back their loan in contrast to the individuals having an immediacy bias (Sprenger and Meier 2012, 2). Since often microfinance clients do not have much time to decide about getting a loan they might end up buying a product that neither suits them nor is reasonably priced. Credit decisions made under these conditions make microfinance clients prone to over-indebtedness.

Finally, cognitive and psychological biases may also set *limits to the ability to be an entrepreneur*, because not everybody is a born entrepreneur. Although it is a fact that mainly poor people are depending on self-employment because of a lack of wage jobs, it is evident that not all of them are ready to or are qualified to be an entrepreneur (Karnani 2007, 38). This may lead to money mismanagement and bad business decisions and may peak in over-indebtedness.

10.1.1.3.2 Sociological Influence Factors

The three main sociological factors influencing the debt management of clients are consumerism, economic socialization, and support of the family. *Consumerism*, as the focus on material goods, is an issue in microfinance. The consumption of goods represents one's standing and identity in a society. This phenomenon is not exclusively observed in the realm of microfinance. Nevertheless, it is evident that the social pressure of consumption may drive clients of microfinance to take up too much debt. Whether borrowers can manage their debt is also dependent on their *economic socialization*. Economic socialization includes how acquainted clients are with money management, and debt management specifically. For example, if current borrowers can draw on experiences from their parents and how they managed their money and debt, it helps them to successfully manage their own debt or at least avoid the mistakes their parents might have made in the past (Stone and Maury 2006, 554). Inversely, a lack of economic socialization might add to the risk of over-indebtedness. Furthermore, feeling obliged to *support family members* at any cost is rooted in many cultures. The responsibility many borrowers feel towards their family and community - meaning that they feel obliged to support them financially – may lead to irresponsible borrowing (Schicks 2010, 13).

10.1.1.3.3 Socio-Demographic and Economic Factors

Also socio-demographic and economic factors might provide explanations why clients take up unmanageable debt. Some of the *socio-demographic factors* where over-indebtedness among microfinance clients is prominent are the following[35]: young age, many and small children, lack of education, illiteracy, and illness. The most prominent *economic factors* negatively impacting the debt management are low income, unemployment, money mismanagement and income fluctuations (Anderloni and Vandone 2008, 15; Collins et al. 2011, 478). Gonzales (2008, 100) shows that loans are often partly used for consumption instead of being completely used for economic activity. Therefore, returns on investments – meaning the returns on the given loans – cannot be as high as assumed by lenders. Borrowers might consequently not be able to repay on time and run into debt stress and eventually into over-indebtedness.

[35] For further socio-demographic factors that may lead to over-indebtedness, see Schicks (2010, 13–14).

10.1.2 Causes of Over-Indebtedness: Results

The causes of over-indebtedness are various and clients are prone to over-indebtedness due to external, institutional, systemic and individual factors. The following figure summarizes the many variables influencing the manageability of debt of a microfinance client. To the question of how many potential causes of over-indebtedness must be put into effect to trigger over-indebtedness, there is no conclusive answer. It is most likely and also Schicks (2010, 15) argues that a credit relationship which ends with the borrower being over-indebted is normally the outcome of many interacting factors.

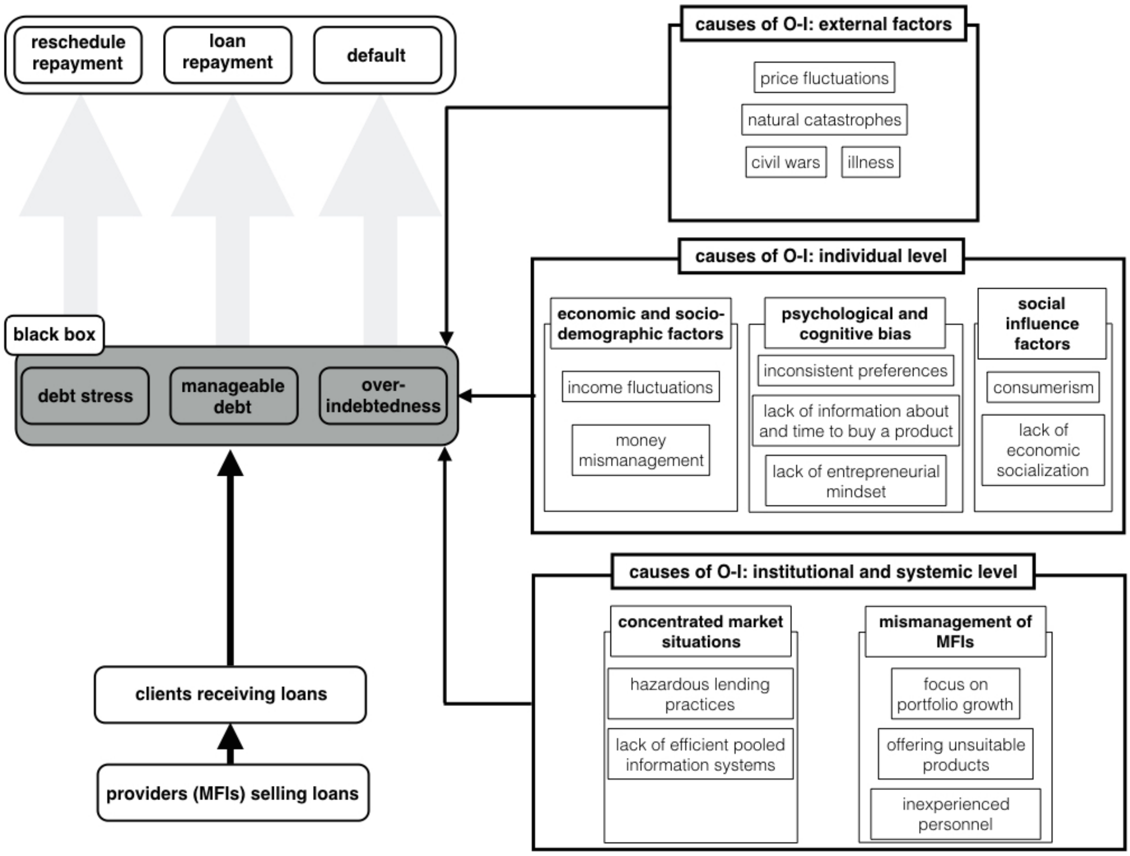

Figure 3: The Causes of Over-Indebtedness (O-I) (own figure)

In the succeeding chapter, the consequences of over-indebtedness are discussed to finally address the implications of how to tackle over-indebtedness in microfinance and mitigate not only its wide-ranging consequences on the individual, but also on the institutional and systemic level in Chapters 10.2 and 10.3.

10.1.3 Consequences of Over-Indebtedness

The consequences of over-indebtedness are manifold. Over-indebted clients feel the immediate effects. In addition, institutional and systemic effects might occur as the numbers of over-indebted clients rise. Providing an overview of the consequences of over-indebtedness they are separately discussed on the individual, institutional and systemic level. It has to be noted that sometimes there is no clear-cut differentiation between the three levels. I tried to take into consideration that consequences materializing on the individual level might also translate into consequences on the institutional and systemic level and vice versa.

10.1.3.1 Consequences on the Individual Level

The definition of over-indebtedness as used here emphasizes the unduly high sacrifices a borrower has to make in order to repay outstanding loans. On the individual level there are mainly five consequences: material repercussions, and sociological, psychological and physical consequences. The fifth consequence is that with the rising number of over-indebted borrowers, clients managing their debt well might be incentivized to default as well and suffer the same consequences as the already over-indebted.

10.1.3.1.1 Material Consequences

Probably the most obvious consequences are material repercussions. Immediate consequences are felt if the loan contract allows for the *seizure of collateral*, such as tools, utensils or other assets (Van Bastelaer 2000, 12). Therefore, the household might lack vital assets. Regardless of what the loan contract states in case of default, an over-indebted client will primarily start to reduce her expenses and sell assets she has to spare (Gonzalez 2010, 29). Cutting down on expenditures could also mean to downsize her business, for example to have to let go an employee. To reduce expenses thus means to make unduly high sacrifices to still make ends meet. Depending on the existence of pooled information systems, a client may also face a negative entry in her credit record and her future credit worthiness could be jeopardized. Lastly, there is a severe risk of over-indebted borrowers starting or continuing cross-borrowing, which will make the borrowers' situations even worse (Schicks 2011a, 5). This strategy, at best, delays the material costs of a default.

10.1.3.1.2 Sociological, Psychological, and Physical Consequences

There are also sociological, psychological, and physical consequences of over-indebtedness felt on the individual level. Being associated with debt is negatively connoted in many cultures. In microfinance there are reports about compulsive acts against defaulting clients. In group lending schemes the pressure among peers may accumulate to the unbearable. Smets and Bähre (2004, 228–232) show with several cases how humiliation, scolding and threats of force are common in group lending. Also there have been reports about aggressive collection practices, such as seizure and harassments, of MFIs applying individual lending (Karnani 2007, 52; Hulme 2000, 27). In general, the stigma of being over-indebted may decrease one's self-confidence. Also a client's social capital deteriorates due to loss of reputation and standing in the community (Guérin et al. 2014, 144–145). Debt stress and over-indebtedness does not only mark an intervention in one's private finances but also has serious effects on a person's life in general. Numerous studies have pointed to correlations between psychological health and debt[36]. Studies show that debt stress correlates with depression, lack of self-control and general decrease of psychological health (Sweet et al. 2013, 98–99; Brown, Taylor, and Price 2005, 647–648; Webley and Nyhus 2001, 442; Drentea and Lavrakas 2000, 527).

[36] Webley and Nyhus (2001, 440) point out that clear causal relations between debt stress and psychological health are inconclusive. Debt stress can have a negative impact on psychological well-being but also psychological problems may impact debt levels in a negative sense.

Furthermore, the negative psychological effects caused by debt stress and over-indebtedness may lead to physical problems. Studies report the correlation between over-indebtedness and weak performance and absenteeism of work (Kim and Garman 2003)[37]. Unfortunately, and as seen in the crises in Andra Pradesh, over-indebted borrowers even committed suicide (Hulme 2000, 27).

10.1.3.1.3 Consequences for Clients Handling Their Debt Well

Finally, negative effects do not only emerge among over-indebted clients but also among borrowers who manage their debt well. If an MFI, in a first phase, shows flexibility in regard to defaulting clients, no-risk borrowers might perceive strategic defaults as a favorable option because they do not fear any repercussions. When a significant part of clients are unable to pay, the government might intervene with debt releases and bailouts. This may even provoke opportunistic behavior from no-risk borrowers and borrowers that face debt stress. Gonzalez (2008, 36) argues that this may have happened in Bolivia during the microfinance crisis from 1999 to 2001 when the government announced debtor consortia and debt releases. There are reports of comparable developments in Nicaragua and India (Schicks 2010, 10).

10.1.3.2 Consequences on the Institutional Level

MFIs face great institutional risks in regard to over-indebtedness among its client base. The main two points are that high numbers of over-indebted clients threaten the financial sustainability of MFIs and potentially diminish their reputation.

[37] For a more complete literature review on the psychological consequences of debt stress and over-indebtedness, see Sweet et al. (2013).

10.1.3.2.1 Consequences for the Financial Sustainability of MFIs

MFIs have to write-off delinquent loans and these write-offs will translate into definite losses in income statements. Rosenberg (1999, 4) states that if an MFI writes off only five percent of its loan portfolio, the MFI might be lulled in a false sense of security. Rosenberg describes how thin the line between managing and losing control of these apparently moderate default levels is[38]. Apparently, losses on the outstanding portfolio have negative effects on the financial sustainability of an MFI. This effect is furthermore fed by the additional necessary expenditures (i.e. increased screening monitoring and collection costs) the MFI has to take when confronted with defaulting clients (Rosenberg 1999, 1). Stearns (1991) states that MFIs will rather reschedule and sometimes also refinance loans than write them off in the first place.

> *Because refinancing and rescheduling convert a delinquent loan into one that is suddenly back on schedule with no arrears (even though the borrower may be just as unlikely to repay as before), they [the MFIs] can disguise serious repayment problems. […] If frequently used, the rescheduling and refinancing of loans can render meaningless any measure of delinquency or repayment, as delinquency rates can be kept very low, and repayments high, even though the portfolio may be of poor quality. (Stearns 1991, 26–27)*

One could argue that accepting a certain level of delinquency and therefore hope for late repayments and keeping monitoring, screening and collection costs low might be a worthwhile trade-off. However, Schicks (2010, 10) claims that MFIs cannot absorb a client portfolio that is severely lacking repayments at least not in the long run.

[38] See Rosenberg (1999, 4) for mathematical examples.

10.1.3.2.2 Reputational Loss as a Consequence

There are also reputational risks MFIs might face if many of their borrowers are over-indebted. These reputational risks are multifaceted. *First*, if a certain MFI is known for selling bad quality loans, normally low-risk borrowers will react and turn their backs on this institution. The market dynamic behind this phenomenon is adverse selection. As described in Chapter 5.3.2.1.1, adverse selection leads to suboptimal outcomes. Good clients will move out of the market because they are only willing to take out a loan for a certain price and only from an institution that has a good reputation. Therefore, MFIs will, without even knowing, give out loans to riskier clients. *Second*, also the perception of the general public, the media and government about the MFI's quality of services is important regarding reputational risks. As seen in Nicaragua, the general public might back delinquent clients and non-repayment movements so a complete collapse of a market can arise. In addition, the media is also capable of ruining the MFI's reputation. The Wall Street Journal, Times of India, and the New York Times have published critical articles about how certain MFIs contributed to the microfinance crisis in Andhra Pradesh. The MFIs were accused of being partly responsible for the suicides and community banishments that happened during the crisis (Feasley 2011, 3). Also governments may play a key role in regard to the reputation of MFIs by labeling microfinance markets exploitative and intervene with regulations such as interest caps (Feasley 2011, 11–13). *Third*, bad reputation of particular MFIs or of a whole sector may alienate important partners of MFIs. Donors, investors and development agencies might withdraw their money and make transfers to other MFIs or markets. *Fourth*, a loss in reputation may eventually lead to a decrease of staff motivation and identification with the employer. This makes „high staff turn-over" likely, which will again add to low quality lending practices (Schicks 2011a, 11; Drexler and Schoar 2014).

10.1.3.3 Consequences on the Systemic Level

Reputation risks and financial sustainability problems are the two most important consequences of over-indebtedness on the institutional level, with the potential to trigger severe systemic effects. As addressed above, the bad reputation of a single MFI can have negative effects on other MFIs and on the microfinance sector as a whole in a country but also on a global scale. Coupled with lower returns on portfolios, there is the eventual risk of alienating investors, development agencies and donors. This can have a global and significant impact on the availability of capital for the microfinance sector. The severity of systemic risks born by over-indebtedness may increase with the microfinance market's size and its interwoveness with the formal banking sector. In many countries there are formal banks providing standard credit, microcredit services and deposits. Hence, spillover effects are to be taken seriously. If formal banks lose their financial stability savings of average non-borrowing clients will be in danger (Schicks 2011a, 11). The adverse selection problem discussed above may lead to diverse consequences. Either the MFIs continue lending and they may run into lending to risky borrowers, or MFIs are aware of the prevailing over-indebtedness in the market and might temporarily cease the financing of credits (even to credit-worthy individuals) due to the higher probability of picking a risky borrower. Both strategies may have effects on a systemic level. If one considers one of the causes of over-indebtedness, namely the lack of thorough client screening and monitoring, MFIs would have to invest more in these „unproductive uses and activities" (Ardic, Ibrahim, and Mylenko 2011; Brix and McKee 2010; Davel 2013; McKee 2013; McKee, Lahaye, and Koning 2011; DeVaney 2006; Tiwari, Khandelwal, and Ramji 2009; Schicks 2010; Lumpkin 2010; Koning and McKee 2011; Chien 2012; Responsible Finance Forum 2011; Center for Financial Inclusion at ACCION 2013). Money, MFIs normally do not have or want to spend in these situations.

10.2 Results and Implications

In the following, I shortly recapitulate the results of the analysis of the causes of over-indebtedness and summarize the insights gained from the preceding analysis of the consequences of over-indebtedness. Finally, policy implications in regard to what approaches could tackle over-indebtedness that can be drawn from my analysis are presented in seven hypotheses with seven corresponding implications.

The main triggers for over-indebtedness are

I. *external factors* including price fluctuations, natural catastrophes, civil wars, and illness,

II. *institutional and systemic factors* comprising hazardous lending practices, lack of efficient pooled information systems, growth focus, unsuitable product offerings, and inexperienced personnel, and

III. *individual factors* encompassing income fluctuations, money mismanagement, inconsistent preferences, lack of information, immediacy bias, lack of entrepreneurial mindset, consumerism, and lack of economic socialization.

As presented in the analysis of the consequences of over-indebtedness, repercussions are far-reaching and devastating for the BoP but also for MFIs and microfinance markets. The main insights regarding the consequences over-indebtedness has on the *individual level* are:

I. The *material consequences* of over-indebtedness on households are severe. Expenses have to be radically cut down or vital assets have to be sold. Also households might be forced to downsize their business.

II. The *sociological, psychological and physical repercussions* are wide-ranging. The stigma of being over-indebted might weigh heavy on the household. Over-indebted borrowers might suffer from depression and from a decrease in their performance at work.

III. If MFIs are not enforcing defaulting clients' contracts by rejecting them from future loans, *borrowers, which manage their debt well*, might be incentivized to default too. The same effect is proposed in the case of countries' announcing debt releases and bailouts.

The main insights regarding the consequences over-indebtedness has on the *institutional level* are:

I. Great losses in the outstanding portfolio cannot be absorbed by a MFI, at least not in the long run. Over-indebtedness severely *threatens* the MFI's *financial sustainability*.

II. High numbers of over-indebted clients may lead to *reputational losses* of single MFIs but also of microfinance markets. The general public, media or also governments, may trigger these losses. If suffering from reputational loss, MFIs and microfinance markets have to regain the trust of investors and donors to continue their investments.

The main insights regarding the consequences over-indebtedness has on the *systemic level* are:

I. Bad reputation of a whole microfinance market coupled with lower returns on portfolios of MFIs with high numbers of over-indebted clients will *alienate investors, development agencies and donors*.

II. *Spillover effects* might be *serious* if the microfinance market has reached a certain size and is intertwined with the formal banking sector. The savings of non-borrowing clients could be at risk if formal banks lose their financial stability.

To answer the overarching question of Part II of this research project – How can the risks of over-indebtedness among microfinance clients be mitigated? – I derive seven hypotheses, which illustrate and combine insights gained from the preceding analysis of the causes and consequences of over-indebtedness. These hypotheses (H1-H7) serve as a base to brainstorm possible implications (I1-I7) of how to mitigate over-indebtedness. One thesis is always followed by one or more implications. Finally, three approaches of how to mitigate the risk of over-indebtedness are present.

10.2.1 External Factors Hypothesis and Implication

H1 Unexpected shocks, such as price fluctuations or natural catastrophe, lead to higher risks of over-indebtedness among microfinance clients.

I1 Despite the fact that external shocks are often unforeseeable, MFIs and governments are aware of the fact that microfinance clients are prone to such shocks. It is therefore important that MFIs and governments regulating microfinance markets take into account that microfinance clients are particularly vulnerable when either having them as clients or being subjects to regulations.

10.2.2 Institutional and Systemic Perspective Hypotheses and Implications

H2 Saturated markets often trigger aggressive commercialization, which leads to higher risks of over-indebtedness among microfinance clients.

I2 Aggressive selling practices feature credit offers and advertising that are phrased and presented in a non-transparent and misleading manner (Porteous 2009, 7). Taking advantage of information asymmetries should be mitigated by either soft law standards or consumer protection regulation demanding, for example, truth-in-lending.

Furthermore, it was highlighted that clients are often not aware of their rights and could perceive even aggressive lending and collection practices as normal (Schicks 2010, 11). Increasing educational levels, especially in regard to finances is key to raising awareness of good and bad practices in microfinance (Brix and McKee 2010, 6, 9, 21, 29).

H3 Unsuitable microfinance products lead to higher risks of over-indebtedness among microfinance clients.

I3 Clients favor products that are easily accessible and that are flexible in regard to their cash flows (interview with an associate of Musoni, The Smart Campaign 2012, 2). Seasonality (e.g. harvest period, raining season) is therefore central to product design (Schicks 2010, 10). Soft law standards could take into account that microfinance clients are highly dependent on seasonality and that products need to be more flexible. MFIs should screen their clients thoroughly in order to, not only assess their creditworthiness, but also their product needs. As a result, living up to the standard of matching clients with suitable products would increase the probability of repayment and mitigate the risk of over-indebtedness (Brix and McKee 2010, 13).

Also in this case, it would benefit the clients, if they had more knowledge about finance and the products offered to them (Brix and McKee 2010, 16).

H4 A lack of pooled information systems leads to higher risks of over-indebtedness among clients.

I4 Microfinance clients do cross-borrow. Pooled information systems, such as credit bureaus and informal credit information sharing among MFIs, serve the purpose of allowing MFIs to inspect information of their clients' credit histories (Brix and McKee 2010, 15). As argued above, these systems have weaknesses. Yet, pooled information systems are one possibility to make – at least – some credit information available to MFIs. Hence, either with state regulation setting in place a credit bureau or MFIs agreeing to exchange credit information among themselves cross-borrowing could be detected and addressed by MFIs (Brix and McKee 2010, 15).

10.2.3 Client Perspective Hypotheses and Implications

H5 Psychological and cognitive biases, such as having inconsistent time preferences or low financial literacy, lead to higher risks of over-indebtedness among microfinance clients.

I5 Individuals possess bounded rationality and their decisions are therefore limited by existing information, their cognitive capabilities and the time available in order to take a decision (Goodwin et al. 2015, 184; Simon 1972, 163–164). It is important that MFIs are aware of the psychological and cognitive biases their potential clients may have. Financial literacy among microfinance clients is mostly low and clients are susceptible to marketing. The disclosure of relevant information to the client before signing a contract seems to be crucial. Barr et al. (2012: 40) state that before signing a mortgage contract, it is key for a mortgage borrower to be presented with coherent information that is written in simple terms. Studies show that loans that are offered in plain language are favored over more complex offers (Bertrand, Mullainathan, and Shafir 2004, 421). Again either state regulation or soft law standards could set rules of how financial products' terms have to be disclosed.

People living at the BoP generally have low levels of financial literacy. Clients could take better-informed decisions, if they had more knowledge about microfinance products and the contracts they are signing (Schicks 2010, 12).

H6 Social influence factors, such as consumerism, expose microfinance clients to higher risks of over-indebtedness.

I6 As argued above, consumerism is an issue in microfinance. Although most of the loans are given out to start, maintain or expand a business, in many cases, clients also use the loan to satisfy short-term consumption needs (Gonzalez 2008, 100). It is important to recognize that societal pressures of consumerism may represent sources that cause clients to make bad decisions in regard to taking out loans. However and agreeing with Schicks (2010, 13), we should refrain from „denying to the poor what we value in our own society”. It is important to recognize that societal pressures of consumerism may represent sources that cause clients to make bad decisions in regard to taking out loans. Consumerism is a fact that MFIs should be aware of and may address consumption needs of a household, when they assess its creditworthiness.

Furthermore, microfinance clients might feel obliged to support their family or community financially. This may lead to irresponsible borrowing (Schicks 2010, 13). Also in this case, being aware that clients can also serve as local support systems, MFIs can address the issue of the support of other family members or relatives.

H7 Socio-demographic and economic factors, such as income fluctuations or money mismanagement, lead to higher risks of over-indebtedness among microfinance clients.

I7 Especially young clients with low education levels and many or small children tend to take up unmanageable debt (Schicks 2010, 13–14). Also characteristically, they struggle with money management and suffer from income fluctuations (Anderloni and Vandone 2008, 15; Collins et al. 2011, 478). On the one hand, an increase in financial literacy would help clients to, for example, better manage their financial in- and out-flows over the repayment period (Schicks 2010, 12). On the other hand, MFIs could assess socio-demographic and economic factors when they evaluate the creditworthiness and financial situation of their clients to offer suitable products.

10.3 Three Approaches to Mitigate Over-Indebtedness

The preceding analysis revealed roughly three possibilities to alleviate over-indebtedness.

I. Setting in place *state regulations*, which aim to balance the information asymmetries between the MFI and its client.

II. Setting in place *financial literacy programs*, which help microfinance clients to make informed decisions about the financial products they purchase.

III. Setting in place *soft law standards*, which help to establish a best practice among MFIs of how to supply financial products to the BoP.

The results of my analysis go together with policy recommendations provided in literature. Scholars mainly address three suitable approaches to fight over-indebtedness (Ardic, Ibrahim, and Mylenko 2011; Davel 2013; Brix and McKee 2010; McKee 2013; McKee, Lahaye, and Koning 2011; DeVaney 2006; Tiwari, Khandelwal, and Ramji 2009; Schicks 2010; Lumpkin 2010; Koning and McKee 2011; Responsible Finance Forum 2011; Chien 2012; Center for Financial Inclusion at ACCION 2013): state regulations, financial literacy programs, and soft law standards.

Being aware of the many factors that may drive borrowers into over-indebtedness, it is key that the various stakeholders of microfinance set measures in place combating as many causes of over-indebtedness as possible. In this regard, Schicks (2010, 15) rightfully points out that none of these approaches ensures a complete absence of over-indebtedness in microfinance. It is therefore also crucial to think of and set in place „curative and rehabilitative" client protection procedures, which are also discussed in Part IV of this research project.

11 Conclusion

Due to the fact that money is fungible after entering a household, MFIs only have insufficient knowledge of what happens between loaning the money and being repaid. In that period MFIs struggle to know how well a client manages her debt. Despite the insecurity about how clients will use their loans, it was argued in Part I that MFIs can elicit a certain repayment behavior from their clients by setting incentives with specific lending techniques. However, the fact that a client repays her loan does not necessarily mean she is managing all her debt well. She could, for example, have repaid her outstanding loan with another one and already find herself in serious debt stress.

The detailed analysis of the causes of over-indebtedness revealed the many triggers on the individual, institutional, and systemic level. As diverse the causes are, the consequences of over-indebtedness may be far-reaching and devastating. Over-indebtedness seriously threatens the well-being of clients, the financial sustainability of MFIs, and the systemic stability of microfinance markets. The analysis suggests that microfinance stakeholders should reduce the risks of over-indebtedness from different angles and by these means protect microfinance clients. In doing so the negative spill over effects of over-indebtedness on MFIs and microfinance markets can be alleviated. Also literature holds the view that different actors should contribute to protecting microfinance clients from over-indebtedness: the state by employing consumer protection regulation, the MFIs and other stakeholders by establishing and applying soft law standards, and a range of actors (e.g. state, NGOs, MFIs) by creating educational programs to enhance financial literacy (Schicks and Rosenberg 2011; Schicks 2010; Gonzalez and Lopez 2012; McKee, Lahaye, and Koning 2011; Brix and McKee 2010; Chien 2012). Based on these coherences there is a need for a more comprehensive framework that accounts for the mitigation of over-indebtedness. This practical framework should be built upon and compatible with the extended definition of microfinance.

In the following Parts III and IV of this research endeavor, it is argued that the extended definition of microfinance in combination with the three approaches to face over-indebtedness can be connected to an encompassing framework, which potentially adds to the lasting protection of microfinance clients. Representing a coordinated and cooperative effort of a diverse set of public and private actors it is introduced as the 'multi-stakeholder framework of responsible microfinance' and includes state regulations, financial literacy programs, and soft law standards that fight over-indebtedness.

In Part III, I argue that there is a close link between the extended definition of microfinance and the framework of responsible microfinance. *First*, responsible microfinance is defined. *Second* and this is the main target of Part III, I underpin the framework of responsible microfinance with an approach to responsibility. In other words I elucidate on the meaning and functions responsibility could have in such a framework. In Part IV, I concentrate on shedding light on the different approaches (i.e. state regulations, financial literacy endeavors, soft law standards) deduced from Part II and analyze the potential of tangible strategies to mitigate over-indebtedness.

Part III – Towards a Framework of Responsible Microfinance

12 From the Extended Definition to a Framework of Responsible Microfinance

Part III of this research endeavor elucidates how microfinance stakeholders could establish a framework of responsible microfinance within which individual, as well as institutional and systemic risks connected to over-indebtedness among microfinance clients, can be alleviated. In Part I, it was emphasized how the quality of MFIs' services potentially affects their clients. The quality of services is closely linked to the risk of microfinance clients to slide into over-indebtedness. However, over-indebtedness levels among microfinance clients do not solely depend on whether or not MFIs comply with client protection standards. It is rather the interplay of many factors that may enhance the risk of getting over-indebted, including psychological and cognitive biases, sociological influence factors, external factors, regulations and political interferences as the analysis in Part II revealed. The many causes of over-indebtedness mirror the difficulty to find „the one solution" to minimize the risk of over-indebtedness. Over-indebtedness cannot be mitigated with one solution but has to be addressed by different actors from several angles including more than MFIs focusing on how to supply microfinance products. Therefore, Part III connects the extended understanding of microfinance to a comprehensive framework of responsible microfinance and has two main goals:

I. Responsible microfinance is a practical framework that lacks a common definition. I construct a possible common definition of responsible microfinance.
II. Literature neglects further to define the possible functions 'responsibility' could have within this framework. Therefore, a specific focus is put on the possible meanings of responsibility within this

framework. The aim is to underpin the framework of responsible microfinance with an approach to responsibility hoping to spark a debate about how narrow or wide responsibility shall be interpreted in responsible microfinance.

The overarching research question for Part III therefore is: What is responsible microfinance and how could responsibility be interpreted in this context?

Part III is structured as follows: After introducing Part III in Chapter 12, I develop the concept of responsible microfinance and categorize it as being a specific domain of responsible finance in Chapter 13. Responsible microfinance is based on the assumption that due to the vulnerability of microfinance clients and the threats and risks over-indebtedness pose to the individual well-being, the MFI's financial sustainability and the systemic stability, microfinance stakeholders have a responsibility to mitigate the risks of over-indebtedness. On the bases of the following three demands of responsible microfinance that McKee, Lahaye, and Koning (2011) refer to, I develop a definition of responsible microfinance that is currently lacking: MFIs balance their financial and social performance, which includes not only making profit but also have client protection and social performance management in place (1), microfinance stakeholders contribute to enabling and enforcing responsible microfinance (2), and microfinance stakeholders have a responsibility to mitigate over-indebtedness, and MFIs are specifically required to hold themselves responsible for achieving their social mission (3). The first two demands of responsible microfinance are both subject to Part IV of this research project. In this part, I exclusively elaborate on the overall demand of responsible microfinance: responsibility. A specific focus is laid upon the MFI and its responsibility to mitigate over-indebtedness.

The meaning of the concept of responsibility in regard to responsible finance or responsible microfinance is, to the best of my knowledge, indeterminate. Therefore, I underpin the framework of responsible microfinance with an approach to responsibility in Chapter 14. What does responsibility in the context of microfinance mean? And further, could MFIs, as the main actors in the framework of responsible microfinance, be held responsible, legally or morally, if they fall short of their own commitment or the exogenously attributed responsibility. Can corporate agents in general be held responsible for their conduct? With reference to Pettit (2007b) it is argued that MFIs would at least have a moral obligation to act upon their responsibility and could be socially sanctioned for their harmful conduct. Concluding remarks are provided in Chapter 15.

13 Responsible Microfinance: A Definition and its Three Demands

The framework of responsible microfinance is, within the scope of this study, introduced as a specification of an already existing framework, which finds its roots in the post global financial and economic crisis debate: „responsible finance"[39] [40] (McKee, Lahaye, and Koning 2011; Brix and McKee 2010; Social Performance Task Force 2012; Koning and Wardle 2014; Responsible Finance Forum 2011; UNPRI 2015). The aim of responsible finance is that key stakeholders (i.e. providers of financial services, regulators, consumers, advocacy organizations) get active in the areas of creating regulations, enhancing financial literacy, and establishing and abiding by voluntary standards (Responsible Finance Forum 2011, 7). Responsible finance, is however, a term of wide comprehension, including a diverse set of types of businesses. It aims, among other things, to mitigate over-indebtedness. In the following, I advocate keeping the main cornerstones of the responsible finance framework but further sharpen and concretize it to the specific case of microfinance.

[39] In this regard, special importance is ascribed to the Responsible Finance Forum (RFF), which coined the term responsible finance around 2010 (see for example Responsible Finance Forum 2011).

[40] Responsible finance took on further practical significance in the process of the implementation of many public and private initiatives, such as the Financial Inclusion 2020 campaign initiated by the Center for Financial Inclusion at Accion, Visa Inc. and Citi in 2013. The campaign emphasizes the responsibility financial service providers have to, for example, treat their clients and employees with respect, design appropriate products or apply transparent pricing (Center for Financial Inclusion at ACCION 2013, 32).

The main institution that is working to form a concept of responsible finance is the Responsible Finance Forum. „[A]n interinstitutional community of practice for knowledge exchange and consensus building on responsible finance" (Responsible Finance Forum 2013, VI)[41], which concentrates on establishing a framework of responsible finance that is widely applicable and aims at „creating more transparent, inclusive and equitable financial markets" (Responsible Finance Forum 2011, 1; Responsible Finance Forum 2013, 1; Haebig and Gross 2012, 10). Responsible finance as a concept is still a work in progress. In the original consultation draft of 2011, the Responsible Finance Forum has shown an equal focus on the microfinance and commercial banking sector. Later publications, like a report concerning the catalytic function of responsible finance to enhance responsible business, define responsible finance also as „creating more transparent, inclusive and equitable financial markets" (Responsible Finance Forum 2011, 1), however, only with a focus on „sustainable/responsible lending", „sustainable/responsible investment" and „impact investing" (Haebig and Gross 2012, 10–12) giving more weight to, for example, environmental, social and governance standards (ESGs) as they are commonly known and applied in the commercial banking sector. Hence, responsible finance serves as an umbrella term including all sorts of endeavors making financial markets more transparent, inclusive and equitable. There are mostly broad definitions of responsible finance to be found in literature, such as responsible finance serves as a „guiding principle for how financial services should be delivered to live up to the challenge of promoting sustainable development" (Responsible Finance Forum 2011, 2) or responsible finance is the „delivery of retail financial services in a transparent and equitable fashion. The focus is on products, processes, and policies that appropriately balance customers' interests with those of providers' and avoid harmful or unfair treatment" (Brix and McKee 2010, 1).

[41] The founding bodies include the German Federal Ministry for Economic Cooperation and Development (BMZ), the Consultative Group to Assist the Poor (CGAP), and the International Finance Corporation (IFC).

Responsible finance is a broad concept that is equally applicable to traditional finance and to microfinance (McKee, Lahaye, and Koning 2011; Responsible Finance Forum 2011; Brix and McKee 2010; McKee 2013). Therefore, microfinance is normally subsumed under the term responsible finance (Responsible Finance Forum 2011, 1; McKee, Lahaye, and Koning 2011; Brix and McKee 2010). In this research project however, responsible microfinance is developed as a specific case of responsible finance. Although responsible microfinance is based on the existing responsible finance framework, it has its particularities accruing from the microfinance business. The *first* and main reason for this distinction is connected to the associations we have with finance. Finance is linked to many proceedings we observe in the economy. It ranges from having a bank account, to loaning money to the BoP, making stock offerings or investing in the private equity of a firm. So responsible finance is rightfully associated with the many areas that finance covers, for example how to invest responsibly (Responsible Finance Forum 2011, 10)[42]. Microfinance in contrast is concerned with a very specific business supplying products to a specific clientele. *Second*, microfinance always faces vulnerable clients as was argued in Part I of this research project. This is different in finance, where intermediaries predominantly work with average clients[43]. *Third*, the motives of finance and microfinance can differ greatly. Microfinance, by definition, has a social mission and does not mainly aim to make profit as

[42] See for example the voluntary United Nations-Supported Principles for Responsible Investments (UNPRI), which emphasize the importance of environmental, social and governance (ESG) factors of investing (UNPRI 2015). The Equator Principles are another case of soft law principles to come under responsible finance (Equator Principles 2011). They aim to mitigate environmental and social risks that can evolve in project financing. One example could read as follows: An investor enters into a contract with a mining company in Zambia whose workers suffer from bad working conditions. The Equator Principles concern such situations and demand the investor to address this deficiency. The investor hereinafter either refrains from investing or only invests if the investee meets certain conditions, such as improving working conditions.

[43] See again the distinction between vulnerable and average consumers. The average consumer is defined by the ECJ as „reasonably well informed and reasonably observant and circumspect" (Case C-210/96 Gut Springenheide and Tusky [1998] ECR I-4657, para 31. Online: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:61996CJ0210&from=EN [last accessed 25.04.2016]). In contrast, vulnerable consumers need a more intense level of protection relative to other consumers (Benöhr 2013, 17, 22, 23; Cartwright 2011, 7–8; see also Case C-382/87, Buet v Ministh·e Public [1989] ECR 1235, para. 13. Online: http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:61987CJ0382&from=EN [last accessed 25.04.2016]).

finance does[44]. *Finally*, literature addresses one point that the authors underline as being especially applicable to microfinance and not to finance in general. It is the objective of social performance management (McKee, Lahaye, and Koning 2011, 3; see also Responsible Finance Forum 2011, 10). Social performance management evaluates whether MFIs succeed in attaining their social mission. Finance normally does not make use of such instruments since the main focus is the financial performance. On the bases of these four arguments in favor of a distinction between responsible finance and responsible microfinance, I argue that responsible microfinance is, at best, a specific case of 'responsible finance' and that is why exclusively the term 'responsible microfinance' is used hereafter. Since finance and microfinance are based on different premises and applied to varying working fields of finance and microfinance I discriminate and understand them as two separate concepts. Also the so far described coherences in this research project are limited to microfinance and to guard against and remove ambiguity, I henceforth use the term responsible microfinance.

The concept of „responsible microfinance" serves as a connecting factor to embed the extended definition of microfinance into a comprehensive framework, meaning a framework that does not only address MFIs but also other microfinance stakeholders (e.g. investors, clients, regulators, NGOs). It accounts for the roles all the actors involved in such a framework may take. The concept is based on the assumption that due to the threats over-indebtedness poses to the individual well-being, the MFIs' financial sustainability and the systemic stability, microfinance stakeholders have a responsibility to mitigate over-indebtedness. McKee, Lahaye, and Koning

[44] Finance primarily aims to make profit. Admittedly, not only since the global financial and economic crisis there is a growing debate in philosophy, ethics and economics about responsibilities the financial sector bears and takes towards its clients and society that go beyond making profit (Ratner 2001; Neuhäuser 2011; Addo 2014). However, traditionally there is no further social purpose driving the business of financial institutions other than maybe creating jobs. The social dimension comes into play however – and with social I mean something a corporation does, which has a direct or indirect positive impact for society – when the corporations business is somehow connected to a wider corporate social responsibility strategy. In fact, one could argue that responsible finance can be well understood as an instrument to further the corporate social responsibility of financial institutions.

understand responsible microfinance both as an „end-state vision" and as „a pragmatic focus on client protection and social performance management" (2011, 1). They provide three main elements to describe responsible microfinance (McKee, Lahaye, and Koning 2011, 2):

I. Due to the vulnerability of microfinance clients, microfinance social mission, and the risks over-indebtedness brings to the individual, institutional, and systemic level, microfinance stakeholders have a general responsibility to mitigate over-indebtedness. Additionally, the responsible microfinance definition specifically requires MFIs to hold themselves responsible for achieving their social mission.

II. Responsible microfinance further demands the financial performance of MFIs to be balanced with the benefits of the clients. Therefore, MFIs should have an eye on both, their social as well as their financial performance. MFIs are defined by pursuing a double-bottom line. MFIs hence want to achieve a social mission and at the same time aim to reach profitability. Traditionally, MFIs measure their financial performance with established financial indicators (e.g. return on investments (ROI)) and their social performance with indicators that mirror the progress the MFI makes in reaching their intentional clientele, empowering women or how the provided financial services fit clients' needs and cause positive effects on the livelihoods of their clients (McKee, Lahaye, and Koning 2011, 3)[45].

III. The final demand of responsible microfinance is that stakeholders establish and sustain a framework within which responsible microfinance can be enabled and enforced (see also Brix and McKee 2010; McKee 2013; Responsible Finance Forum 2011). Actors involved in such a framework could include main actors such as MFIs, microfinance clients, governments, but also investors, donors, NGOs and IOs.

[45] Against the pertaining theory that microfinance cannot be done without a trade-off between social and financial performance and that investors will consequently lose interest in MFIs that focus on both (Cull, Demirgüç-Kunt, and Morduch 2009; Cull, Demirgüç-Kunt, and Morduch 2011; Vishwanath and Kaufmann 2001), recent surveys show that there is no significant loss if the MFI focuses on financial and social performance (Dewez and Neisa 2009; Bassem 2012; Argüello et al. 2013; Augustine 2012).

Inferred from the three elements and mainly referring to McKee, Lahaye, and Koning (2011, 2), I deduce the following definition of responsible microfinance:

> *Responsible microfinance is characterized by MFIs that balance their financial and social performance. MFIs should aim to initiate or have procedures in place to hold themselves responsible for achieving their social mission, which includes the implementation of client protection and social performance management. Furthermore, stakeholders such as MFIs, governments, investors, donors, NGOs and international organizations try to create and maintain a framework that enables responsible microfinance and further the coordination of their actions and their cooperation. Responsible microfinance thereby focuses on the three areas of action (i.e. state regulation, financial literacy, soft law standards) to especially enhance consumer protection and thereby mitigate over-indebtedness.*

The demand for enabling and enforcing responsible microfinance is the main subject of Part IV of this research project and the demand to balance the financial and social performance is addressed in Chapter 19 of Part IV. In the following, I concentrate on the overall demand of responsible microfinance, which is responsibility. A special focus is put on the MFIs and their responsibility to mitigate over-indebtedness among their clients.

14 The Overall Demand for Responsibility in Responsible Microfinance

In general responsibility is referred to as an obligation or duty (Bentham 1970, 294) to adequately perform or complete a task that we either commit ourselves to, in the sense of a promise, or that we are appointed to from an authority[46], in the sense of an exogenous assignment (Raz 1988, 82; Simmons 1979, 76). Failing to fulfill that obligation normally implies that sanctions are appropriate; these can have a legal or social character. This common understanding of responsibility refers to possible sources and consequences of responsibility. Sources of responsibility could either be for example that a state, society or a NGO delegates certain tasks to a certain agent ('exogenous assignment') or that a commitment is voiced by the same agent as the one who is taking the responsibility ('promise' or 'self-commitment'). Finally, being the addressee of a responsibility translates into bearing a duty, which, if not fulfilled, implies the appropriateness of a sanction as a consequence.

Acknowledging the demand for balancing the financial and social performance, and the demand for enabling and enforcing responsible microfinance, the definition also requires MFIs to hold themselves responsible for achieving their social mission. Furthermore, a general claim that microfinance stakeholders are responsible to mitigate over-indebtedness underlies the framework of responsible microfinance. There are two main issues in regard to having responsibilities and holding someone responsible. *First*, responsible microfinance is based on the assumption that due to the vulnerability of microfinance clients, the social mission of microfinance, the threats over-indebtedness pose to the individual well-being, the MFI's financial sustainability and the systemic stability, microfinance stakeholders have a responsibility to mitigate over-

[46] Raz (1988) uses the concept of a 'legitimate' authority and explains what is necessary in order for an authority to be legitimate. For the extent of this research project, this cannot be further discussed. An authority in this context is defined as an entity, which has a certain influence and voice in regard to MFIs doing their business. Authorities can be NGOs, states, transnational and international organizations, or investors.

indebtedness. *Second*, the responsible microfinance definition requires MFIs „to aim to initiate or have procedures in place to hold themselves responsible for achieving their social mission, which includes the implementation of client protection and social performance management". This requirement primarily allows for two interpretations. Either the MFI commits itself to take steps that prove its responsibility by the means of self-reporting, such as publishing annual reports about the state and progress of the MFI's social performance, and more specifically evaluating their progress regarding their client protection and social performance endeavors. Or the MFI decides to abide by specific social performance and client protection standards (e.g. Universal Standards for Social Performance Management, Smart Campaign's Client Protection Principles). In this case the MFI consents to undertake the obligation to obey these standards and risks getting sanctioned for non-compliance[47].

In this chapter, it is briefly sketched why and towards whom MFIs, states, clients, NGOs and international and transnational organization, and investors potentially bear responsibility. Possible consequences, such as social or legal sanctions, of these obligations are presented. Furthermore, it is examined whether MFIs as group agents can be held responsible for their harmful conduct. With reference to Pettit (2007b) it is argued that MFIs would at least have a moral obligation to act upon their responsibility and could be socially sanctioned for their non-compliance. Additionally, it is debated how these insights are applicable to the context of microfinance.

[47] As we will see, the sanctions for soft law standards are normally of a social and not legal character.

14.1 Sources and Consequences of Responsibility

Below, I describe the responsibilities MFIs, states, clients, NGOs, and international and transnational organizations, and investors potentially have in the context of microfinance and especially in regard to minimizing over-indebtedness. Note that this chapter is summarily and there is no completeness claimed.

Microfinance Institutions (MFIs)

In regard to MFIs it makes sense to proceed from the extended definition to evaluate the potential obligations MFIs have in a framework of responsible microfinance. There are three sources of responsibility for the MFI, which fall into the category of 'self-commitment':

I. It is the MFI's responsibility to provide small-scale financial services that might include credit, savings, insurance and money transfer to low-income individuals or low-income communities[48]. Hence, the duty of the MFI is to provide products and fulfill the contracts it entered into with its clients.

II. The second source of responsibility is to comply with certain standards, without being certified or actively endorse such standards, while doing their business. This duty accrues from the social mission inherent in microfinance, the fact that MFIs supply products to potentially vulnerable clients, and over-indebtedness crises that have lately occurred.

III. MFIs also have a responsibility towards their employees and their shareholders. MFIs have the duty to act according to the employment contracts they enter with their employees and to keep their agreements with shareholders.

There are also duties, which are exogenously ascribed to MFIs by other stakeholders, such as the state, clients, NGOs, international and transnational organizations, and investors. These claims seem to find their justification in the post over-indebtedness crises being a demonstration

[48] The outstanding balance of microfinance products should thereby not exceed 250 percent of the averaging income per person (GNI per capita).

effect showing that some MFIs had in fact conducted harmful practices. In the aftermath, many initiatives and regulations established by transnational organizations (e.g. Smart Campaign, Social Performance Task Force), international organizations (IOs) (e.g. UN Guidelines for Consumer Protection, UN Guiding Principles on Business and Human Rights) and states (e.g. consumer protection regulations) emerged and assigned MFIs with the obligations of refraining from harmful practices and of better protecting their clients, if they pledge themselves to abide by one of these standards.

States

The state commits itself to protecting microfinance clients and has an interest in mitigating institutional and systemic risks. This commitment stems from the general idea that the state protects its citizens, also in regard to products that may threaten their health-related, social or economic well-being (Adcock 2014, 228; W. Wilson 1898, 42; Heyman 1991; Beermann 2014). But states also have tasks that are assigned to them. Governments traditionally depend on their constituency. If citizens do not agree with certain policies, they will voice their disapproval and will not vote for the ruling party or parties, or will voice their disapproval with the government through other channels (e.g. demonstrations, riots, putsches). Also responsibility that is assigned from advocacy organizations and IOs to states increases. Pressure rises from civil society organizations and may affect policy choices in certain areas.

Clients

In the form of a commitment, clients may, at the moment of purchase, make a commitment to themselves that if they take out a loan they also want to repay[49]. In the form of an exogenous assignment, MFIs but also the state assign certain tasks to microfinance clients. For example clients should exercise care when taking out a loan and be aware of the consequences a

[49] This assumption however only holds if clients have given their informed consent to the product they purchase or if they do not already plan on strategically defaulting when purchasing a product.

non-repayment may have, such as a negative entry in their credit record that might lead to being rejected for future loans or simply a worsening of their own life situation.

Transnational and International Organizations (IOs)

Transnational organizations commit to a certain issue voluntarily. They may be assigned with responsibility from other actors, such as states, NGOs, MFIs, clients and investors. Transnational organizations, as in the case of Smart Campaign, aim to simplify communication and coordination between several actors regarding the specific topic of microfinance client protection. If they act against their self-commitment or against exogenously assigned responsibility, they probably will suffer from reputational damage and internal dividedness.

IOs are state-centered institutions, and tasks are traditionally received from the international community of states (Archer 2001: 33). Ever since the 1990s though this view has been challenged and the UN increasingly allows for stakeholder participation. In case of acting against self-commitments and exogenously received responsibilities, IOs might lose in reputation and might suffer from internal dividedness.

Investors

Investors can commit themselves to protect clients from over-indebtedness indirectly through their investor policy. They could, for example, only invest money in MFIs that underwent a due diligence in regard to their social performance and client protection endeavors. Hence, investors may apply a specific investment policy accounting for factors such as minimal standards their investees must meet. Investors can also be assigned with responsibility from actors such as MFIs, states, and transnational and international organizations. Also investors might call upon themselves in order to apply certain investment standards. So a group of investors might also build awareness among other investors to follow their example. One case is the Equator Principles, a soft law framework built by financial institutions, which aims to minimize environmental and social risks that are likely to arise in project financing (Equator Principles 2013, 2). If investors do not live up to the responsibilities they commit to or are assigned from other actors, they most probably suffer from reputational damage and might be flagged as untrusted or irresponsible investors. If there was also a hard law forbidding certain business conduct of investors, they would obviously not only suffer from social but also legal sanctions.

In the following chapter, I discuss the consequences of responsibility for MFIs in detail and turn to an issue, which is part of an ongoing debate in philosophy, business ethics and international law on how to understand business entities' responsibilities towards society, clients and the environment (Neuhäuser 2011; Ratner 2001; OHCHR 2011; Prior and Argandoña 2009; Michalowski 2012; OECD 2011; Ruggie 2013; Pettit 2007b). The main question is: Can corporate agents, such as MFIs, be held responsible for their conduct? This question follows from the definition of responsible microfinance stating that MFIs hold themselves responsible for achieving their social mission, which includes the implementation of client protection and social performance management and the overarching claim of responsible microfinance that all stakeholders bear the responsibility to mitigate over-indebtedness. However if we can hold MFIs responsible for their conduct, it is a question of whether MFIs as group agents are fit to be held responsible. In line with Pettit, it is deliberated that MFIs are in fact fit to be held responsible for their actions, at least morally, and that neglecting this responsibility implies sanctions, at least social ones.

14.2 Discussing Responsibility and Corporate Actors

If we assume that we take the concept of responsible microfinance seriously, so that especially MFIs account for the risks that arise when working with extremely vulnerable clients, there are two main questions arising. How could the demand for responsibility be translated into practice and how could a certain control be established? This is an important question, which is addressed in Part IV.

If we take one step back, there is however an equally important question to ask. Responsible microfinance but also responsible finance uses the term 'responsibility' without defining it or addressing the issues that might result from using the concept of responsibility within the corporate context. And, given the fact that MFIs are corporate agents, the question arises whether MFIs are even fit to be held responsible in the case they contravene their responsibilities (e.g. obliging by certain standards in doing business with vulnerable microfinance clients but still conducting harmful practices). This question is the subject of this chapter.

The overarching claim of responsible microfinance is that it lies in the responsibility of microfinance stakeholders to mitigate over-indebtedness among microfinance clients. What happens however if MFIs, which are the focus of this chapter, fail to take this responsibility? If MFIs cannot live up to the soft law standards they pledge to obey and thereby jeopardize the social and economic well-being of their clients, is there a way to hold the MFIs responsible? Many scholars negate the assumption that corporations as group agents can be held responsible for transgressing regulations or soft law standards. They deny corporations' moral or legal responsibilities and claim that responsibility can only be attributed to individuals, such as the employees of a corporation or their chief officers (May 1987; Crane 2002 paraphrazed in Pettit 2007b, 172). In order to be morally responsible corporations require the capability of agency, rationality, and autonomy. Methodological individualists defend the view that only individuals can be moral persons. Agency, rationality and autonomy cannot be ascribed to corporations they argue. Individuals are seen as real, and observable persons. Corporations however are understood as abstractions that cannot be directly observed (Fisse and Braithwaite 1988, 476). The overarching debate in metaphysics is between nominalists and realists. Nominalism understands corporations as an aggregation of individuals where there is no collective personality. In contrast, realists see corporations as being a moral and legal body in itself. Assuming that corporations are only collections of individuals moral and legal responsibility cannot be ascribed to the corporation as such but to its individual employees. Realists assume that corporations are more than collections of individuals. They conceptualize corporations as actors to whom moral and legal responsibilities could be ascribed (Soares 2003, 144). The idea that legal and moral responsibility can be attributed to corporations and that on these grounds, corporations can be in fact held responsible for their wrongdoing is elaborated in the following. Doing so, I mainly consult the work of Pettit, which advocates still a „minority position" that responsibility cannot only be assigned to a corporate actor but also corporate actors can be held responsible for their conduct even when individual responsibility is lacking (Pettit 2007b, 172)[50].

In his article, „Responsibility Incorporated", Philip Pettit argues that corporate agents are fit to be held responsible for their actions. He takes the example of Herald of Free Enterprise, a ferry that sank in the English Channel on March 6, 1987. Almost 200 people drowned and it soon became clear that the company running this ferry majorly neglected its maintenance and did not carry out the usual routines to ensure its operationality. Despite the obvious sloppiness of the company operating the Herald of Free Enterprise, the company did not undergo any punishment because the courts could not attribute fault to specific individuals (Pettit 2007b, 171). In this regard, Colvin (1995, 18) cited a commentator on the case: „The primary requirement of finding an individual who was liable […] stood in the way of attaching any significance to the organizational sloppiness that had been found by the official inquiry". Pettit infers that although individuals may lack a „high degree of personal responsibility, together as a corporate

[50] For similar positions, please see French (1979; 1984) and French, Nesteruk, and Risser (1992).

enterprise they should carry full responsibility for what occurred". He advocates that even when no responsibility can be assigned to an individual the incorporated agency induces incorporated responsibility. If Pettit's theory on the fitness of corporate actors to be seen as moral and legal persons and that they can in fact be held responsible for their actions can serve as a foundation for the framework of responsible microfinance is assessed in the following. A common understanding that corporations can be conceptualized as moral and legal entities – and that therefore corporations cannot easily ascribe responsibility to single persons, especially if the wrongdoing was done or connected to many decisions that had been taken by a diverse set of employees from different levels – potentially minimizes the risk of corporations to hide behind responsibility-diffusion scenarios where they simply attribute the responsibility to the one who sits at the desk where the buck stops.

Hereinafter, I introduce Pettit's views on the responsibility of corporate actors and follow his line of argument in answering the questions:

I. What are corporate agents?
II. What does holding responsible mean?
III. Which conditions render a corporate agent fit to be held responsible?
IV. Do corporate agents meet these conditions and if so, is there an argument in favor of applying these conditions even in combination with proof of a personal responsibility?

As a last step, I discuss the applicability of Pettit's theory to the context of responsible microfinance.

14.3 What Are Corporate Agents?

Pettit (2007b, 172) gives a wide definition of corporate agents. The term is interchangeably used with corporations, group agents, and organizations. Corporate agents may be universities, NGOs, firms, political parties, churches, but also looser „collections of individuals" such as partnerships, voluntary organizations, and town meetings. The main agents of these entities are their members, staff or representatives. However, the corporate identity of a bank is not altered if this bank lets go a large part of its personnel. The tasks to be done will be the same; only the agents executing them will be different ones. Normally, corporate agents have procedures in place of how to go about achieving certain benchmarks, like growth and profit margins, numbers of members or achieving a certain impact for a certain cause. Corporate agents apply processes to check whether they have attained their goals and review the decisions they have been taken to reach these goals. If decisions turned out to be hurtful to the goals set, they would have procedures in place to adjust either the goals or the ways to make decisions. Depending on the corporate agent, the method of applying changes either follows a rather participatory approach as typical for voluntary organizations or a rather hierarchical approach as typical for companies.

14.4 Holding Responsible: What Does it Mean?

In Pettit's understanding, holding responsible is best defined in the distinction to other related attitudes, such as causal responsibility, holding someone accountable, or thinking someone responsible. *First*, being held responsible is more than just perceiving a causal responsibility for something that has been done. Pettit uses the example of domestic animals. If your cat soils the carpet in your living room, you can clearly assign the causal responsibility to your cat. However, that is not the understanding Pettit has of being held responsible. The cat urinated on your carpet. What has been done is bad, you might be frustrated and you might intensify her training but she is no agent that is a „candidate for blame". So, holding someone responsible differs from „the mere assignment of causal responsibility" (Pettit 2007b, 173). *Second*, holding someone responsible is different from holding someone accountable. Holding responsible is more than just identifying one person that puts her neck on the line for something that was wrongfully done or raises a cheer for something done which is praiseworthy. A parent might be accountable for what the underage son has done. However, the parents are not responsible for his behavior, he is. In contrast to being held accountable, being held responsible comes with many more conditions that have to be fulfilled. *Third*, being held responsible includes one further element than just thinking a person is responsible. By thinking a person is responsible, we assume that this person is also blame- or praiseworthy. Holding this person responsible would however include actually blaming or approving this person. In the case when something bad has been done, eschewing the blame denies that there is some sort of creditor: That there is „someone to whom at least an apology is owed" (Pettit 2007b, 174).

Pettit's understanding of holding responsible hence encompasses three steps. If an agent is causally responsible for something good or bad she is a candidate for blame or approval. However an agent is only held „responsible when we go one further step and actually blame or approve" (Pettit 2007b, 173). So, the agent who is a candidate for blame or approval has to actually get blamed or approved. In a last step, what she has done has to be identified „with the stance of a creditor – someone to whom a debt is owed" (Pettit 2007b, 174). In sum, Pettit asks for three elements in order to hold someone responsible: Causality, blame- or praiseworthiness of an action, and action calling for a compensation of some kind.

14.5 *Are Corporate Agents Fit to Be Held Responsible?*

In the foregoing chapter the necessary elements of holding someone responsible are presented. Applying these three elements to the group agent case and giving an answer to the question, when group agents are to be fully held responsible for their conduct, is the focus in the following.

In line with other political philosophers and based on the Roman Catholic moral theology[51], Pettit proposes to adopt the following three necessary conditions to assess whether a group agent is fit to be held responsible (see also Neuhäuser 2011, 57; Hart 1968, 140 f.).

> *Value relevance. – The group is an autonomous agent that faces a significant choice between doing something good or bad or right or wrong.*
>
> *Value judgment. – The group has the understanding and access to evidence required for being able to make judgments about the relative value of such options.*
>
> *Value sensitivity. – The group has the control required for being able to choose between options on the basis of its judgments about their respective value. (Pettit 2007b, 177)*

In order to evaluate whether corporate agents can also be held responsible, three questions are addressed:

- Q1 Does a collective of individuals constitute an agent and can this group be understood as an autonomous agent?
- Q2 Are group agents capable of making value judgments?
- Q3 Are group agents capable of acting in line with value judgments they make?

[51] The necessary conditions for a mortal sin being it must be a grave matter (1), it must be committed with full knowledge (2), and it must be committed with deliberate consent (3) (Pope John Paul II 1984).

14.5.1 First Condition – Value Relevance

For the first condition, it boils down to the question whether or not group agents qualify as autonomous agents, because if they do, they – at least at some point – will have to make value-relevant choices. To answer this question, it has to be elaborated whether a collective of individuals constitutes an agent and whether this group can be understood as an autonomous agent. In doing so, Pettit (2007b, 178) argues in favor of both statements.

T1 Groups may constitute agents.

T2 Groups may constitute autonomous agents.

In the following, I describe Pettit's argument (T1 and T2) claiming that group agents can be held responsible in the scope of the first condition.

(T1) Groups may constitute agents

In order for an individual or group to qualify as an agent, they have to form and reform

1. „action-suited desires" that are realizable and describe how the environment should be and
2. „action-suited beliefs" that are „sensitive to incoming evidence" and describe how the environment currently is (Pettit 2007b, 178).

An agent then should be able to act upon the analysis of how it is and how it should be. If the belief does not yet match the desire, the agent will reform the current situation until the desire is realized. In reality, someone or something that aims to qualify as an agent may not in every single case succeed to form his, her or its desires or to act upon these desires. However, an agent must generally „display a robust pattern of attitudinal and behavioral rationality" (Pettit 2007b, 178). Pettit (2007b, 178) illustrates these systems of beliefs and desires with an example of robots and argues that even a simple robot can qualify as an agent. Imagine a wheeled robot that rolls around on a table. There are various cylinder-shaped objects scattered all over the table. The robot has arms to put them in different positions. This robot is equipped with an „on-off desire", which is „cylinders should be upright". The robot has a device to scan the table for objects. As soon as it spots a cylinder lying on its side (i.e. belief), it approaches the object and acts according to its desire. It uses its robotic arms to put the object into the desired, upright position. Although some of the objects lying nearer to the edges of the table might get pushed off, the observer would still notice the pattern of behavioral rationality the robot follows[52]. If we can accept a simple, or more complex robot as an example of an autonomous agent, we can also accept corporate agents, which are equipped with more complex systems of beliefs and desires, which their agency follows to be autonomous agents in the light of this analysis.

In order for a group agent to act on certain desires it should implement „conditions that ensure agency" (Pettit 2007b, 179). Therefore, group agents have some sort of shared intention to perform tasks as a „single unified agent". Every single individual does her bit to enable the agent to act in a certain way. However, being able to act as a unified agent does not mean that every individual has to have the same knowledge or influence concerning the detailed strategies of such an agent. Whereas some may play big roles in decision taking processes, others may only be aware of the role they are required to play. Nevertheless, every single member of a group agent has its role, whether it is big or small, to create an action-suited body of desire and belief. Group agents might coordinate themselves differently. Most commonly though they will form a leading group of

[52] McFarland (2000, 34–40) presents a detailed analysis if and how machines might be able to make rational choices. He concludes that robots can show behavioral rationality of the process they are designed to follow. Let us take the example of a robot working in an assembly line of a car manufacturer, which is programmed to assemble one side of the car. Imagine that the robot is not only capable of lifting a car door and putting it into a certain position, but is also able to install the door at the correct spot on the car body. Furthermore, the robot is programmed in such a way that it is able to detect whether the doors it is assembling are defective or accurate. Hence, the robot is able to decide between superior and inferior choices. His desire is much more complex then the desire of the robot on the table (i.e. „cylinders should be upright"). A more complex robot has several desires that come in a certain order. To be mounted to the car body, the „doors should be accurate" if they are not, they are put in a certain box. If the robot's scan detects a defective door (i.e. belief), it acts according to its desire when doors are defective, namely „defective doors should be put in box y". If the robot's scan detects an accurate door (i.e. belief), it acts upon its desire when doors are accurate, namely „accurate doors should be mounted to the car body".

members that will deliberate about the agent's goals and action plans (i.e. desires). Subgroups or single individuals will implement these plans and will report the progress to their superiors. Hence, they assess how a certain task is executed (i.e. belief) and how it should be executed under the new proposition (i.e. desire) given by an authorized group. Periodically, the leading group or subgroup leaders will assess whether their goals and action plans are successfully accomplished or if their adjustments to the strategy have to be made. Under this analysis, group agents can be understood as agents.

(T2) Groups may constitute autonomous agents

Groups may only constitute an autonomous agent, when there is evidence that a group attitude is not only the result of a „summative kind" as Quinton (1976, 17) called it. French (2016) presents the methodological individualism view on corporations as follows:

> *[A corporation] is understood to be nothing more than a contractual nexus, a collection of self-interested humans acting either as principals or agents with respect to each other. […] A corporation is but the financial and contractual 'playing field' for a number of individual dealings, and it has no existence independent of those dealings.*

This traditional view of group attitudes is however hard to advocate against the backdrop of existing group agents, which are equipped with highly complex decision making procedures and organizational structures. This is why defenders of the traditional view like Quinton apply their theory of how group attitudes are formed to participatory agents[53] only. Imagine a participatory group is about to decide on a certain question. Every single member of that group voices her opinion about whether to answer the question with no or yes. The resulting group attitude is, for Quinton, a mere majoritarian function of the corresponding attitudes of every individual participating in the decision making process. Pettit confronts this view by claiming that due to 'discursive dilemmas' there is no „general rule group

[53] In a participatory group all individual members participate not only the vocal few.

attitudes can be a majoritarian function of member attitudes" (2007b, 181)[54]. And associated impossibility theorems as they are presented in List and Pettit (2002, 96–100) elucidate that group attitudes cannot be a majoritarian or non-majoritarian function of individual attitudes. To illustrate this point Pettit (2001, 271–276) uses the example of a 'discursive dilemma'. The staff of a company can vote whether they want to waive a pay-rise in favor of enhancing security measures to protect them from electrocution at their workplaces. The employees will consider two questions:

1. How serious is the threat of being electrocuted at my work desk?
2. Is the money that all employees will forego enough in order to minimize the risk of being electrocuted in such a way that it would eliminate the seriousness of the threat of this event?

Each employee has to deliberate the seriousness- and the effectiveness-question in order to decide on whether to sacrifice the pay-rise or not. Imagine the following decision matrix:

	Seriousness (S)?	Effectiveness (E)?	Pay-Sacrifice (P)?
Member A.	Yes	No	No
Member B.	No	Yes	No
Member C.	Yes	Yes	Yes

This matrix illustrates that the outcome differs on whether the decision is driven by the premises (first two columns), or whether the decision is driven by the conclusion (Pettit 2001, 273). Although a majority of the staff supports the premises, the pay-sacrifice is rejected. Should the opinions on the premises or the ones on the conclusion drive the group decision?

A majoritarian system to decide on certain issues shows a lot of inconsistency in the outcome of such a vote. A solution could be to apply a

[54] Law and economics scholars working in the field of social-choice described discursive dilemmas that occur while aggregating judgments and called them the doctrinal paradox (Kornhauser 1992, 442; see also Kornhauser 1986; Brennan 2001; B. Chapman 1998), also in political science Daudt and Rea discussed the compound outcomes of majority decisions and developed the Ostrogorski-Paradox (1976).

procedure allowing for internally consistent decisions of the group agent. Such a procedure means that decisions of a group agent would no longer be a mere majoritarian function of the individuals attitudes „and will cast it to that extent as an autonomous subject" (Pettit 2007b, 182). Autonomy is possible if group judgments are „functionally independent" of the corresponding individual attitudes. How could autonomy be proved in practice?

List and Pettit (2008) and Pettit (2007a) present some possibilities how to establish autonomy and I briefly point out two of them. *First*, group judgments to be rational judgments cannot be functionally dependent on the individual judgments of the group members but they „must be a function of their individual sets of judgments across many propositions" (List and Pettit 2008, 85). In order to know what the group thinks about a certain proposition, such as S, E or P, it is negligible to know each individual opinion about a single proposition. The authors conclude that if group members decide about sets of propositions instead of single propositions, the group agent acts autonomously (2008, 95–97). In this scenario the group takes a majority vote on each of the propositions (i.e. on S and E) and follows a constraint that says that there is only a pay-sacrifice if and only if both propositions (i.e. seriousness and effectiveness) are affirmed. So the propositions are to be looked at together as a set of propositions. This premise-based procedure entails the advantage that with the individual vote on the set of propositions we can automatically establish the group judgment on the issue; hence the individual attitudes on the conclusion R are inadequate to identify the group's decision about the conclusion R but are also superfluous (List and Pettit 2008, 97). *Second*, Pettit (2007a, 512–514) also advocates the straw-vote procedure. This procedure entails to take a straw vote on every issue that has to be discussed. If inconsistency occurs, the procedure allows feedback. The group deliberates about the inconsistency and tries to resolve it. The newly formed judgment comes to a vote again and so on and so forth (Pettit 2007a, 512–513). This procedure focuses on the deliberation about judgments that raise inconsistencies and therefore breaks away from the focus on individual attitudes.

14.5.2 Second Condition – Value Judgment

Can group agents form judgments about the relative value of any options they are confronted with? A judgment will be made over premises that are presented to, for example, a group meeting or a meeting of an authorized subgroup. By following certain procedures (e.g. set-wise decision, straw-vote) this group decides on the issues at hand. Since individuals are able to discuss and bring forward propositions in their private lives, they are also able to present and discuss propositions within a group. Group agents are therefore capable of making judgments about the relative value of options they are confronted with (Pettit 2007b, 187).

14.5.3 Third Condition – Value Sensitivity

I presented Pettit's argument that groups are able to make judgments about the relative value of options they are confronted with. For the third condition, the question is if a group agent is able to respond to these judgments. Are groups in „reason-sensitive control" of their judgments (Pettit 2007b, 188)? Do they reliably take action and follow the judgments they have made? The main problem with advocating in favor of reason sensitivity of groups is on whatever judgment the group acts upon; it will always be an individual member carrying out a certain task in the name of the group agent. It is likely that in practice an individual that acts in a group agent's name is in complete control over how the task is performed and also is likely to be completely responsible for what it is doing. With reference to Thomas Aquinas[55], Pettit (2007b, 189) deduces the following argument:

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[55] In 1946, Eschmann published a paper on corporate delict and collective guilt. He analyzed the writings of Thomas Aquinas and especially his views on society and community. Pettit deduces his argument from the following excerpt: „Excommunication […] is only to be inflicted when one has committed a mortal sin. Now a sin consists in an act. Yet, in most cases, an act is not done by the whole community but by some persons […]. Hence these persons from among the community may be excommunicated, but not the community itself" (Eschmann 1946, 11).

Whatever a group agent does is done by individual agents.

Individuals are in reason-sensitive control of anything that they do and so in control of anything they do in acting for a group.

One and the same action cannot be subject both to the reason-sensitive control of the group agent and to the reason-sensitive control of one or more individuals.

Hence, the group agent cannot be in reason-sensitive control of what it does; such control will always rest with the individuals who act for the group.

As far as this analysis has progressed, the first two premises can be approved. The problem comes with the third premise. Assuming that a group agent only acts reason-sensitive because its individual members do so: Can group agents acquire the reason-sensitive control necessary in order for them to be held responsible?

Pettit affirms this question and makes use of an analogy. Imagine a closed flask filled with water that is brought to its boiling point. Inevitably, the flask breaks into pieces after some time. Pettit argues that there are two critical factors in that process. *First*, the water is boiling. This is described as the higher-level event. Without this requirement, the flask would not break. Thus, the factor 'boiling water' programs the flask to break. *Second*, however the water molecules have to be distributed or moved to bring the water to its boiling point, there will be one molecule that triggers the breaking with its position that is sufficient to break the glass at one point. This is described as the lower-level event. In conclusion, being at boiling temperature the water programs the glass to break and being positioned in a certain way the molecule „implements that program; it plays the immediate productive role" (Pettit 2007b, 191). The higher- and lower-level event (i.e. boiling and triggering the breaking) is causally relevant. Thus, according to the situation we might refer to either of the two causal explanations of how the flask broke.

Imagine a practical case where there is an individual member of a corporate agent fulfilling a certain task on behalf of this group. Is the corporate agent able to exercise reason-sensitive control over how a task is executed? Referring to the analogy with the flask we could infer that the corporate agent can do so because it shares the control. Group agents take on the task of programming what and how something will be done and the individual member undertakes the active role by implementing this program (Pettit 2007b, 191). What the analogy does not cover is how a group can execute reason-sensitive control. As mentioned above, the group is able to form judgments and attitudes of its own and sets constitutions in place, which determine how these attitudes are to be formed. Also this control accounts for which of the individual members will carry out certain tasks in which way and, in case of failure, has a back up plan how to assign this task to other members that are capable of executing this task. Also the individual who is responsible for the task will control her actions in a reason-sensitive way and will ensure that it is she and not someone else carrying out that task. It is therefore the corporate agent, which is responsible in its role as „the ultimate, reason-sensitive planner at its origin". However, not only the group agent has to answer for what it has done, but also the group members have to answer for their actions and thus keep their responsibility as „enactors of the corporate deed" (Pettit 2007b, 192)[56].

14.6 Individual versus Corporate Responsibility

Corporate agents are fit to be held responsible. This was shown in the precedent argument. How though is the relation between individual and corporate responsibility evaluated? If all relevant individuals who are part of a corporate agent and responsible in a certain case are found, would it not be redundant to argue that we also should hold the corporate agent responsible as a whole? Pettit (2007b, 194) advocates the thesis that

[56] Pettit adds the notion that an individual only has responsibility if she could have said no to fulfilling a task but did not. This notion, in my opinion, is debatable since: First, the task could not constitute an obvious wrong-doing, and second, there might be other factors involved such as pressure from superiors or simply „I have to keep my job"-considerations. I doubt that, under these conditions, one could ascribe absolute responsibility to a single person.

although all important enactors of a group can be held responsible, it is vital to be able to hold the corporate agent responsible as well.

Imagine again the ferry disaster in 1987. The sinking of the *Herald of Free Enterprise* in the English Channel caused the drowning of almost 200 people. As mentioned above, the court assessed that the corporation operating this ferry was extremely sloppy in maintaining the ship. The corporation omitted to properly maintain, repair and check the ship. In this case, the court did not manage to assign any responsibility to single individuals, since it was the collective and creeping omission that led to the ferry catastrophe. In light of Pettit's argument, the court would have had, at least a moral bases to assign responsibility to the ferry corporation. Under these circumstances, there is no ground to hold individuals responsible for what they have done in the name of a group agent. However, the corporate agent should be held responsible for what it has programmed the individual members to implement. In the case of falling short of attributing responsibility to individual members there is reason to complementarily hold the group agent responsible.

Instead of only seeing group responsibility as a backup if enactor responsibility fails, there are two reasons why we should always consider group responsibility. *First*, to prevent shortfalls in individual responsibility, group responsibility should be assessed by default. *Second*, if there is no regime for group responsibility, individual members may abuse their status within a group to act in such a way that they cannot be held responsible yet profiting from their self-serving conduct. Pettit (2007b, 197) concludes:

> *The regime I envisage would hold individual enactors responsible for any harm that they might have refused to do and didn't. And it would hold the corporate agent responsible for having organized things so that such harm was likely or inevitable.*

14.7 Applicability of Pettit's Theory of Corporate Responsibility to the Responsible Microfinance Framework

One of the goals of this chapter was to define responsibility in regard to the framework of responsible microfinance. Responsibility was introduced as a duty or obligation to satisfactorily perform or complete a task. This task represents either an exogenous assignment or a self-imposed commitment. Not fulfilling this task is blameworthy and makes a sanction appropriate. This sanction can be of legal or social character. Furthermore, I aimed to give the framework of responsible microfinance a foundation, an approach to responsibility, which underpins the framework with a common understanding of the sources and consequences of responsibility in microfinance, which it was lacking before. Pettit's approach on the fitness of corporate actors to be seen as moral and legal persons and on their fitness to be held responsible for their actions, can serve as a possible foundation for the framework of responsible microfinance. If the framework starts out from a common understanding that corporations are responsible for their conduct as moral and legal entities and that they, even if it only concerns soft law standards, can be held responsible for their actions and that they will feel, at least, social sanctions, can help enhance the enforceability of these standards.

Seeing corporations as legal and moral entities might at first not seem to be useful in the realm of soft law standards. However, as shown later in this third part, especially the soft law standards representing one pillar of the responsible microfinance framework are starting to harden and with a common approach of how to understand responsibility the interpretative scope of what responsibility might mean in this regard is inevitably narrowed and exit options and deflecting, are getting increasingly difficult. This topic is therefore closely linked to enforcement issues. Finally if the framework of responsible microfinance ought to have some potential to mitigate over-indebtedness and the therewith-connected individual, institutional and systemic consequences, and aims to be widely recognized and enforceable, having a common understanding of the sources and consequences of responsibility in microfinance is necessary.

15 Conclusion

In Part III, I constructed a definition of responsible microfinance and especially elaborated on its overall demand for responsibility. Putting a focus on responsibility and shedding light on what it could mean within a framework of responsible microfinance was important due to the fact that responsible finance and responsible microfinance literature seem to neglect defining what responsibility and holding MFIs responsible for their conduct could entail. The contribution made to the discussion in this research project is offering one possibility to underpin the framework of responsible microfinance with an approach to responsibility, hoping to have sparked a discussion about how narrow or wide this concept shall be interpreted in the context of responsible microfinance.

In Part IV, I examine ten cases to illustrate how microfinance stakeholders help attain responsible microfinance's demand to enforce and enable practical strategies to mitigate over-indebtedness in each of the three pillars (i.e. state regulations, financial literacy endeavors, soft law standards). Furthermore, the demand for MFIs to balance their financial and social performance and initiate or have procedures in place to hold themselves responsible for achieving their social mission, which includes the implementation of client protection and social performance management, will be addressed in Chapter 19.

PART IV – ENFORCING AND ENABLING RESPONSIBLE MICROFINANCE

16 The Three Pillars of Responsible Microfinance

Responsible microfinance builds upon the extended definition of microfinance presented in Part I of this research project and is a broader framework incorporating various actors which all contribute and cooperate to further and realize the goals of responsible microfinance. It puts an emphasis on the mitigation of the vulnerability of clients against over-indebtedness and in a wider sense also on the alleviation of institutional and systemic risks, which can be triggered by high numbers of over-indebted clients. Its three main pillars are the implications derived from the over-indebtedness analysis in Part II of this research.

- Pillar I: state regulations
- Pillar II: financial literacy endeavors
- Pillar III: soft law standards

In general, responsible microfinance understands the three pillars as key in order to protect microfinance clients from over-indebtedness and therefore also to reduce the individual, institutional and systemic risks connected to it. The three pillars include the practical strategies to enable and enforce responsible microfinance and its targets. In Figure 4 the three pillars and the main microfinance stakeholders involved in the framework are presented.

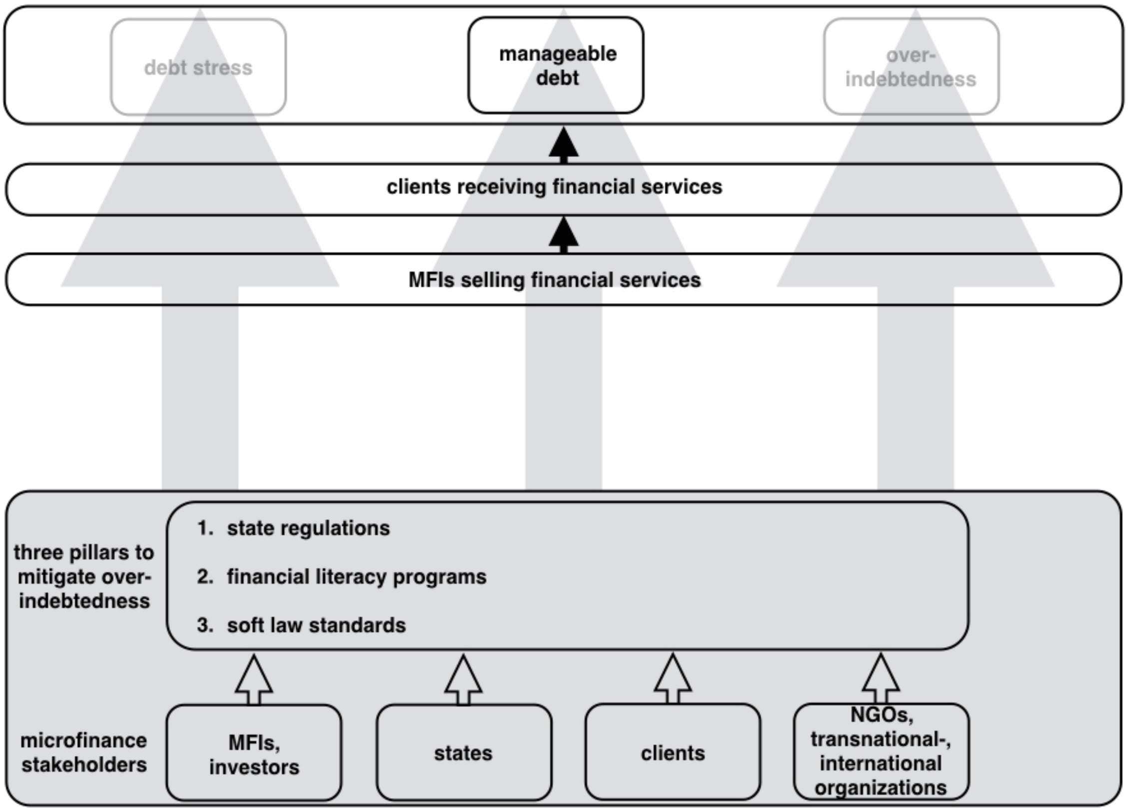

Figure 4: The Multi-Stakeholder Framework of Responsible Microfinance (revised and updated from Responsible Finance Forum 2011)

The demand for enabling and enforcing responsible microfinance applies to the three pillars to mitigate over-indebtedness within the framework of responsible microfinance. These pillars compose the approaches deduced from the analysis in Part II. The definition of responsible microfinance calls for a framework whose structures enhance the coordination and cooperation of the stakeholders in such a way that responsible microfinance is furthered and corresponding standards and regulations that advance the goals of responsible microfinance are better enforceable.

The claim to enable the coordination and cooperation between all stakeholders in regard to responsible microfinance would be relatively easy to attain. MFIs, states, investors, IOs and NGOs, which are already endorsing one or the other standard accounting for responsible microfinance or financial literacy initiative could promote such practices and motivate other actors to do likewise.

The demand for enforceability is also relatively easy to fulfill in regard to state regulations, however more difficult to attain in the case of soft law standards established by transnational and international organizations. Of the three pillars, state regulations are the instrument with most enforceability power to further the goals of responsible microfinance and they may even reinforce the other two pillars. States can implement rules that consider the area of tension between access-friendly market-conduct laws and obstructing policies. Furthermore, they may accelerate and support financial literacy initiatives or help establish, spotlight or even incorporate soft law standards into their regulations. State regulations may also use incentives, such as rewarding good practices (McKee, Lahaye, and Koning 2011, 2). In contrast, soft law standards are by definition voluntary and therefore traditionally lack enforcement power (Abbott and Snidal 2000). Nevertheless, such standards can also become quite powerful. In recent years, standard-setting international and transnational institutions have started to incorporate extensive stakeholder participation into their standard-setting processes to widen recognition and facilitate enforceability.

Financial literacy programs undoubtedly have less of an enforcing power but are crucial to empower clients in regard to their financial knowledge and rights in this regard and raise awareness about the risks connected to over-indebtedness. In this sense, financial literacy endeavors bear the potential to empower microfinance clients in various ways and therefore mitigate the risks of over-indebtedness.

In order to enable and enforce responsible microfinance the framework proceeds from the following three assumptions:

I. State regulations mitigate the risk of over-indebtedness among microfinance clients and the therewith-connected individual, institutional and systemic risks (Chapter 17).
II. Financial literacy programs reduce the risk of over-indebtedness among microfinance clients and the therewith-connected individual, institutional and systemic risks (Chapter 18).

III. Soft law standards mitigate the risk of over-indebtedness among microfinance clients and the therewith-connected individual, institutional and systemic risks (Chapter 19).

Below, the three pillars the analysis of the causes and consequences of over-indebtedness suggested in Part II (i.e. state regulation, financial literacy programs, and soft law standards) are presented and practical strategies that mitigate over-indebtedness in regard to every pillar are explored in order to show how responsible microfinance could be enhanced and enforced. I am comparatively brief on the consumer protection state policies and financial literacy strategies and put the focus on the soft law client protection and social performance standards. The overarching research questions for Part IV are:

- What could a framework of responsible microfinance look like?
- What are the possible actors involved and which practical strategies to mitigate over-indebtedness could they further?

Part IV is structured as follows: The **first pillar** is presented in Chapter 17 and concerns state regulations. I argue three hard cases that contribute to the alleviation of over-indebtedness.

Case I Consumer Protection Regulations

In the past decade, scholars and policymakers have started to recommend consulting behavioral models to help create regulations (Ardic, Ibrahim, and Mylenko 2011; Barr, Mullainathan, and Shafir 2009; Elliehausen 2010). Therefore, regulations should account for what governs the decisions of credit-interested households instead of factoring in the idea of how a rational household should behave.

Starting from these assumptions, it is argued in Chapter 17.1 that consumer protection regulations should include disclosure requirements, rules on fair treatment, and recourse mechanisms. Relying on empirical evidence the potential and limits of the three elements are discussed.

Case II Credit Bureaus

Credit bureaus serve the purpose of helping to detect cross-borrowing. The state is able to identify cross-borrowing tendencies within the microfinance market and MFIs are able to receive information about the creditworthiness of their clients.

In Chapter 17.2 the assets and drawbacks of credit bureaus are examined. Furthermore, existing credit bureaus in South Africa and Ghana are taken into account in order to approximate 'role-model' cases of credit bureaus.

Case III Private Insolvency Systems

In Chapter 17.3 I explore the potential benefits of creating private insolvency systems, which could, as a means of last resort, provide over-indebted microfinance clients with a fresh start.

The **second pillar** affects financial literacy endeavors. In Chapter 18 three practical cases are brought forward to show how financial literacy projects mitigate over-indebtedness.

Case IV SEWA Bank's Financial Literacy Program

Based on the understanding that the provision of financial services should be oriented by an in-depth knowledge of clients' needs (Kilara and Rhyne 2014, 1; Datar, Epstein, and Yuthas 2008, 40; Wardle 2014, 9), I present the case of SEWA Bank in Chapter 18.1, which developed an approach to easily gather the information necessary to assess whether a client needs additional explanation or educational training regarding the products she purchases. In doing so, SEWA Bank can apply educational measures appropriately and punctually to mitigate the risks of over-indebtedness.

Case V The Kenyan Soap Opera 'Makutano Junction'

Makutano Junction, a Kenyan TV educational drama series that disseminates educational content aims to reach a large audience and to educate them on specific issues in an entertaining way is introduced in Chapter 18.2. Referring to empirical evidence, it is shown that the content of educational soap operas in fact has a lasting impact on viewer's perceptions on, for example finances.

Case VI The Gamification of Financial Literacy

The use of game mechanics in non-game contexts (i.e. 'gamification'), such as health or finances, aims to incentivize individuals to learn something about these topics while playing a game. In Chapter 18.3, three digital games are introduced and their applicability in the microfinance context and their potential to mitigate over-indebtedness is assessed.

The **third pillar** presents soft law standards having the potential to mitigate over-indebtedness (Chapter 19). Instead of solely presenting the cases and evaluating their potential to mitigate over-indebtedness, I put a specific focus on soft law standards. Soft law standards are voluntary in character and represent best practices (Mattli and Woods 2009, 3). They have mainly two targets. *First*, they aim to be „technically competent standards" contributing to the coordination between actors and defining concepts, which are key in specific economic domains (Richardson and Eberlein 2011, 217). *Second*, because soft law standard-setting institutions operate outside of the sovereignty of states, the challenge lies within the establishment of standards that are nevertheless legitimate and enforceable (Richardson and Eberlein 2011, 217).

As the main goal of Part IV is to find practical strategies, which do mitigate over-indebtedness and thereby enable and enforce responsible microfinance, it is vital to assess whether the four cases of soft law standards are applicable to the context of microfinance and therefore are 'technically competent'. Furthermore, it is important whether the standards are established in a legitimate way and whether they can be enforced. In order to reflect upon these problems, the analytical framework of the common interest theory of Mattli and Woods (2009, 12–42) is adopted (Chapter 19.1). The analytical framework requires the process of creating soft law standards to be open to a wide array of actors ('institutional supply-side conditions'). However, proper due process and open forums are yet insufficient for a soft law standard to be labeled in the common interest. Being in common interest, these participatory channels have to be actually used by various actors representing the societal demand ('demand-side conditions') for creating or revising these soft law standards. Against the backdrop of the common interest theory, the following four soft law standards are presented (see Chapters 19.2 to 19.5) and analyzed:

- UN Guidelines for Consumer Protection (Case VII – Chapter 19.2)
- UN Guiding Principles on Business and Human Rights (Case VIII – Chapter 19.3)

- Smart Campaign's Client Protection Principles and Certification Program (Case IX – Chapter 19.4)
- The Social Performance Task Force's Universal Standards for Social Performance Management (Case X – Chapter 19.5)

Whether the processes to establish and revise these soft law standards meet the requirements of the common interest theory is argued in Chapter 19.6 to 19.9. Furthermore, the applicability of the four cases to the context of microfinance is discussed in Chapter 19.10.

The conclusion of how the ten cases analyzed contribute to the mitigation of over-indebtedness within a multi-stakeholder framework of responsible microfinance is discussed in Chapter 19.11.

17 Pillar One: State Regulations

Traditionally, consumer protection is one of the three main functions of financial regulation[57]. Financial institutions might conduct their business in an inadequate or harmful way and consumers should be protected from such business practices by state regulation (Staschen 1999, 5). In the following, I draw on three examples for policy implications in the realm of consumer protection regulation that assumingly contribute to the mitigation of risks of over-indebtedness. *Case I* is very much connected to the discussion about behavioral economics in Chapter 10.1.1.3 and elaborates on the question on what consumer protection regulation should entail. *Case II* concerns the possibility states have to mitigate information asymmetries between lenders and borrowers through credit bureaus. And *Case III* addresses the yet widely neglected possibility of implementing personal insolvency systems especially in developing countries where they are usually lacking.

[57] The second function of financial regulation is the maintenance of the systemic stability, which could be threatened by the failure of financial institutions. And the third function is connected to prudential concerns about the liquidity and institutional health of financial institutions (Staschen 1999, 5; Llewellyn 1999, 9, 13–21).

17.1 Case I: Behaviorally Informed Consumer Protection Regulation

As discussed in Chapter 10.1.1.3 neo-classical economic theory assumes that individuals act rationally and with full information when making decisions. However, behavioral research showed that the rationality of consumers is in fact bounded by cognitive biases, the information accessible, and the time available when making a decision (Akerlof 1991, 1; Goodwin et al. 2015, 178, 183). Although empirical behavioral research has shown that human behavior is guided by impulses, conceptions and wishes rather than by deliberative intent or normative ideals, regulators still often rely on the normative analysis that consumers make rational decisions (Barr, Mullainathan, and Shafir 2009, 27).

Barr, Mullainathan, and Shafir (2009, 39–49) take the example of the U.S. mortgage crises and clarify the mismatch between the complex financial products and the common consumer who wanted to buy a house. In the light of classical policy thinking, the behavior of consumers should be guided by rational considerations. Yet in fact, the consumer is lacking perfect information and prudence, which are both presupposed in the context of rational decision-making. Hence, regulations should factor in consumer behavior. The authors hypothesize that if the mortgage products had been straightforward and understandable – in practice they suggested for example an opt-out home mortgage plan with a standard fixed-rate loan – the scope of the crises could have been weakened (2009, 43–49). Due to such studies, researchers and policymakers have recently started to recommend taking behavioral models as an assistance to creating regulations (Ardic, Ibrahim, and Mylenko 2011; Barr, Mullainathan, and Shafir 2009; Elliehausen 2010). Therefore, regulations should account for the reasons that govern the decisions credit-interested households take instead of factoring in the idea of how a rational household should behave.

Disclosure, Fair Treatment and Recourse Mechanisms

The research findings in the field of behavioral economics provide insights regarding how to best mitigate information asymmetries between financial institutions and their clients. These findings are of special importance concerning disclosure requirements. Although there is wide agreement on the key role of disclosure, the challenge how to most effectively disclose information remains. In their policy paper, Porteous and Helms (2005, 3) state that due to transparent disclosing of loan terms to borrowers, borrowing costs can be reduced. Reducing borrowing costs, especially regarding the prevention of excessively high fees and interest rates, is a key policy goal (Porteous and Helms 2005, 4). Often, however, regulators try to reach this goal by setting interest caps, which can have market-distorting effects. Regulating how credit terms have to be disclosed is a less interfering option (Brix and McKee 2010, 8). Clark (2006, 155), Prialé Reyes and Dias (2010, 7), and Chien (2012, 1–2) show that regulations regarding disclosure requirements, have the potential to lower prices and in fact led to a drop in credit costs not only in Cambodia and Peru but also in Eastern Europe and Ghana.

In spite of their importance, *disclosure requirements* vary greatly from country to country and there is no general understanding of them regarding what is to be disclosed, when it has to be disclosed and how the information has to be displayed (Ardic, Ibrahim, and Mylenko 2011, 4). An often-criticized approach is to provide the borrower with as much information as possible. Information overload is though unconducive and diminishes the helpfulness of disclosure (Ebers 2004, 8). Ebers (2004, 8–10) suggests one main approach, „reducing information complexity by standardizing"[58] by using simplified but standardized language (see also Porteous and Helms 2005, 2). There is wide agreement that, especially in low-access environments, consumer protection regulations should draw on simplified

[58] He also suggests „transforming information complexity", which means that there is a multi-level system of information. The highest level contains all information for a certain financial product, the lowest level contains a widely simplified version of all information that is available for a certain product. Hence, even though the borrower might inform herself about a product by the means of the simplified version of product information, she always would have access to all the information available on the product she purchases.

language and that regulations urge MFIs to eschew complex calculations or formulas (Collins et al. 2011, 135; Brix and McKee 2010, 11). Borrowers favor knowing the total costs of a credit product, how much every installment will be and how many installments it will take them to pay off their loan (Chien 2012, 3). By discussing the debate that arose with the first drafted truth-in-lending bills in the United States and Canada in the 1960s, Zeisel and Boschan coined a standard in 1968 declaring what pricing information should be disclosed. This standard is still applicable. They elaborated that „any lender or vendor selling on credit must provide his purchaser with a clear statement of the credited amount, mode of repayment, initial finance charges, true annual interest rate and total amount of interest that will accrue" (Zeisel and Boschan 1968, 827). What current initiatives, such as MFTransparency, in microfinance have in common with Zeisel and Boschan (1968) is how they all try to provide a concise list, a standard, of what information financial institutions ought to disclose to their clients.

Zeisel and Boschan (1968, 828) rightfully state „[t]hat it is a simple task to provide this information". Nevertheless, microfinance practice shows a different picture. Although MFIs might support transparent pricing in theory, many still refrain from transparently disclosing their pricing information. Normally, MFIs should disclose their prices with the annual percentage rate (APR): It „takes into account the amount and timing of all the cash flows associated with the loan, including not only things that are explicitly designated as 'interest' and 'principal' but also any other expected fees or charges, as well as compulsory deposits that are a condition of the loan" (Rosenberg et al. 2013, 4). However, MFIs often present APRs that do not include any charges (e.g. upfront fees, compulsory savings) or say anything about how the interest rate is calculated (i.e. flat or declining interest rates[59]). Hence, MFIs do not evaluate their costs and information

[59] Interest is the price a person pays for his or her loan. How much interest a client pays depends on the interest rate that has been stated and on the method of how interest is calculated, namely based on a flat or declining balance method. When an MFI bases its interest calculation on the full loan amount over one loan cycle it applies the flat interest rates method. When an MFI calculates interest rates „on the outstanding loan balance – the

they disclose with reference to a certain standard of disclosure. This leads to confusions among clients trying to choose between different products from different providers. And, as Chuck Waterfield, the CEO of MFTransparency puts it; even MFIs wishing to display their prices transparently are confronted with incentives suggesting doing the opposite:

> *Once the industry began widely employing confusing product pricing, it became very difficult for MFIs to convert to transparent pricing. To do so, the MFI would advertise what appeared to be the highest price in the market, even though their true price could actually be the lowest. As a result, the vast majority of MFIs practice non-transparent pricing even though many would prefer to do otherwise. (Chuck Waterfield, CEO MFTransparency, 2009 cited in Argüello et al. 2013, 174–175)*

This result is also facilitated by the therewith-connected fear that transparent pricing equals losing clients and suffering financial losses. Argüello et al. (2013, 174) present empirical evidence based on quantitative and qualitative data that suggests otherwise. They cite Xavier Pierluca, Bamboo Chief Investment Officer: „The commercial microfinance sector is about 25 years old. The organizations that have tried to grow and have not practiced transparency have failed" (Xavier Pierluca, Bamboo Chief Investment Officer, cited in Argüello et al. 2013, 194–195). Receiving misleading information, for example about the APR of a loan, deprives clients from taking informed decisions. In contrast, practicing pricing transparency empowers clients to take informed decisions and enhance the economic performance of the MFI[60] (Argüello et al. 2013, 174–175; see also Augustine 2012). Hence, there is neither a practical nor business related reason to refrain from demanding pricing transparency as an imperative

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balance of money that remains in the borrower's hands as the loan is repaid during the loan term" it makes use of the declining or reducing balance method (MFTransparency 2014, 2). Applying the flat interest rate method is much more profitable and results in almost double the revenues in interest compared to the profits resulting from the declining balance method (MFTransparency 2014).

[60] Argüello et al. (2013, 174) also support other implications of pricing transparency, such as healthier competition in microfinance markets and a de-stigmatization of high interest rates that are charged to the extreme poor living in remote and rural areas.

feature of responsible microfinance. Therefore, regulators could help to set clear rules in what has to be disclosed.

Unfortunately, introducing truth-in-lending regulations alone is insufficient to ensure the protection of consumers. Other problems evolve leaving microfinance clients unprotected. For example, there are further products that might not be as easy to understand, such as insurance products, which require different, more complex information to be disclosed. In this case, the interplay of financial literacy and consumer protection regulation comes to the surface. But even if consumers were financially literate and disclosure requirements were obeyed, well-functioning consumer protection regulation is not guaranteed. Again there are other problems, such as inadequate selling practices that may bring large gains to MFIs but leave consumers over-indebted. Hence, *fair treatment* is also playing a key role in regard to effective consumer protection regulation. Nevertheless, if fair treatment requirements are demanded, they should not impede or discourage potential clients from access to financial products. Furthermore, fair treatment requirements are not easy to implement. Each country, maybe even each consumer might have a different perception of what fair treatment might signify (Brix and McKee 2010, 13). Principally, disclosure and fair treatment requirements represent the main regulatory tools to minimize the information asymmetries between providers and borrowers, but there is also a further aspect. If borrowers feel mistreated or want to voice a complaint, it is key that they are able to turn to a third-party *recourse mechanism*. Hence, another element of consumer protection regulation could be that either the state provides microfinance clients with an institution to turn to in case of mistreatment or complaint, such as an ombudsman or a complaints office, or that the state requires the MFIs to establish complaint offices. Brix and McKee (2010, 18) advise that establishing internal dispute resolution mechanisms would be a good start and, at least for the beginning, more feasible than third-party recourse mechanisms imposed by regulators.

17.2 Case II: Credit Bureaus

Credit bureaus serve the purpose of helping to detect cross-borrowing (i.e. taking out loans to repay former loans). The state and MFIs equally benefit from this information. The state is able to identify cross-borrowing within a certain market and MFIs are able to gain information about the creditworthiness of single clients. As was argued above, cross-borrowing is one reason why microfinance clients slide into over-indebtedness. Scholars hypothesize that effective pooled information systems may mitigate over-indebtedness rates among clients (Brix and McKee 2010, 15). There are roughly two ways to gather information about the credit history of clients: credit bureaus run by the state or informal sharing of credit information among MFIs in case of the absence of a credit bureau. The usefulness of such a system is however greatly affected by the sort of information that is collected.

Let me explicate the goals and practicability of information gathering systems using the example of state credit bureaus. *First*, they aim to enable microfinance providers to gain insights into borrowers' current and past debt and repayment history so MFIs can assess the riskiness level of a possible client. *Second*, they aim to prevent borrowers from taking out too many loans that cannot be redeemed and at the same token they help borrowers build up credit records. The *third* goal is that pooling systems help policy makers to gain a market overview. They reveal debt trends in the market as a whole or in certain segments.

Nevertheless, there are reported challenges to information-pooling systems. *Firstly*, often credit bureaus only track the negative records of a client's credit history. Hence, only defaulted loans are registered, which signals MFIs that a client with an entry in a credit information system is by default a risky client and is therefore likelier to be rejected from loans. Although costlier, pooling systems should record positive and negative credit history of clients so that MFIs are provided with a more complete picture of the potential client (Brix and McKee 2010, 15). Yet, there is a growing debate conflicting with the question of the legitimacy of collecting and disclosing any credit information. The debate contrasts the mitigation of over-indebtedness with the privacy of data. This conflict is recognized by a few researchers stating that information gathering systems may only be allowed if there are clear rules guiding the collection process and determining within which scope information might be disclosed (Niemi 2009, 96; Brix and McKee 2010, 16). Brix and McKee (2010, 16) argue that with rising competition in credit markets also governments should foster the accessibility to „high-quality credit information" to facilitate responsible lending and further transparency in the market. Sharing credit information however always bears the risk of eroding client data privacy. The authors suggest establishing procedures accounting for this risk, such as informing clients about the collection and sharing of their credit information with third parties. Furthermore, clients should be informed about what consequences a default has and they should be allowed to look through their credit record and be permitted to correct any erroneous entries. Such systems as the one proposed have already been realized in the South African National Credit Act and the fair credit reporting laws in Ghana (Brix and McKee 2010, 16).

Secondly, many developing countries lack effective credit bureaus. If this is the case, MFIs have the possibility of sharing credit information among them. This strategy though has often proved incomplete, since MFIs share this information voluntarily. MFIs do not have to share any data or, if they do, they might share incomplete information. This results in MFIs lacking the access to reliable information about future clients' debt and repayment records.

Thirdly, existing credit bureaus often exclude MFIs that are not regulated or do not possess a banking license, letting alone the entire informal lending sector (i.e. private money lenders) (Brix and McKee 2010, 16). It is evident, and this also holds true for informal sharing of credit information among MFIs, that information sharing systems might not prove overly effective. However, they constitute one strategy to have, at least, access to some credit history information of clients (Brix and McKee 2010, 16).

17.3 Case III: Private Insolvency Systems

One issue that has not yet been addressed in microfinance literature is the possibility of setting in place or reforming private insolvency systems. As a last resort, besides debt counseling, an office of an ombudsman or MFIs' internal dispute resolution mechanisms, it could be beneficial for over-indebted individuals to have the possibility of escaping from their debts by means provided by private insolvency systems. Almost all European countries know proceedings, which govern insolvency, debt restructuring, bankruptcy and foreclosure in private as well as in the professional sphere. Also the possibility to discharge debt has gained importance in Europe in the past thirty years. England, Austria, France, Germany, Scandinavian and Benelux countries (Niemi 2009, 100–101) and the United States (Miehe 2015) recognize, for example, debt cancellation. Private debt cancellation is also an issue in Eastern European countries. In January 2015, Croatia canceled the debts of approximately 60'000 citizens. Under the condition that a citizen is not earning more than 1,250 Kuna ($184) per month, rents and does not own a property and is not able to liquidate the debts is given up to 35,000 Kuna ($5,146) (Szu 2015). Although a large-scale debt cancellation might be highly political, it also symbolizes that debt is a problem many countries struggle with and that there are no simple solutions to problems such as over-indebtedness, also in industrialized countries.

Analyzing the situation in developing countries there are predominantly no personal insolvency laws in place (Shah 2013). Boraine and Roestoff (2014, 93) and Shah (2013, 33–34) discuss a choice of transition and developing countries, which make it burdensome for own-account workers and small to medium size enterprises (SMEs) to be even eligible for a personal insolvency proceeding (i.e. South Africa) or completely lack such a procedure (i.e. Egypt and Vietnam). In Vietnam, for example, only larger or state-owned enterprises are eligible for bankruptcy procedures. Even owning a registered SME will not allow accessing bankruptcy procedures. The Vietnamese bankruptcy regulation therefore misses the majority of

Vietnamese businesses, which are largely composed of sole proprietors such as household-run businesses (Shah 2013, 34). A further feature of a bankruptcy system considers how fast after a bankruptcy an entrepreneur can again be integrated into the economy. In Australia and also Egypt, entrepreneurs that failed with their business are limited to engage in new ventures or simple legal proceedings because passports of the debtors are seized by either the court in the case of Egypt or the trustee in the case of Australia (Shah 2013, 35).

As stated above, private insolvency systems are a means of last resort; however, they could be useful in the realm of responsible microfinance. Discharging debts can give a microfinance client with a small enterprise a 'fresh start'. Nevertheless, the issue of private insolvency has not been greatly discussed in microfinance literature so far and needs more work. One question would clearly concern the incentives such systems would give to microfinance clients.

17.4 Interim Conclusion – Client Protection Policies

In Chapter 17, I explored three possibilities to mitigate over-indebtedness over state regulations. By considering the insights from behavioral economics, it was shown for *Case I* that consumers do not take purely rational decisions. Their rationality is bounded and consumers often follow their urges and ideas and are not guided by deliberative intent or normative ideals. What microfinance consumer protection regulations should entail was the question addressed for Case I. The first factor was disclosure. The analysis showed that the true APR should be disclosed, including all costs incurred. There is no 'one size fits all approach'. However, literature agrees on the strategy to simplify and standardize information about microfinance products. Policy makers could contribute to this target and set clear rules about how, when and what information should be disclosed. The next two factors discussed were fair treatment and accessible recourse mechanisms. Fair treatment has gained in importance due to abusive lending practices that were increasingly observed within microfinance business conduct. If fair treatment requirements are to be included into consumer protection regulations, they should neither impede nor discourage potential clients from access to financial products. If clients feel mistreated, recourse mechanisms are key because they give the clients an opportunity to voice their complaints and potentially improve their situation. Optimally, these recourse systems are provided by a third-party imposed by regulators, at the moment, however, recourse mechanisms for microfinance clients are still in their infancy so often only MFIs offer internal dispute resolution.

In *Case II*, I presented credit bureaus as a regulatory instrument to mitigate over-indebtedness. By means of pooling information about microfinance clients' credit records, MFIs can more easily detect whether a client may slide into over-indebtedness when taking out another loan or not. If deemed effective or not depends on the type of information gathered and on which financial institutions are designated to share the information. Furthermore, the quality of shared information will suffer if, for example, MFIs share credit information voluntarily due to the absence of a credit bureau.

As a last possibility how states regulations could mitigate over-indebtedness I introduced private insolvency systems as *Case III*. Private insolvency systems are a largely neglected topic in the realm of microfinance. In sum, such systems offer over-indebted households a 'fresh start' and could lift the stigma of being over-indebted. As the examples of Egypt, Vietnam and Australia have illustrated, a private insolvency programs nevertheless may discourage those affected, if hurdles to be eligible for the program or re-entering the economy are too high.

18 Pillar Two: Financial Literacy Programs

As already has been briefly discussed in Chapter 10.1.1.3, low financial literacy seems to be positively correlated with poor financial decisions. Although, empirical research on financial literacy and awareness of financial concepts is sparse, this chapter provides some research findings on the relation between financial literacy and over-indebtedness and presents practicable possibilities of how to enhance financial knowledge.

Over-indebtedness can be prevented, if individuals know their financial in- and outflows and how much they, in total costs, need to pay back for every installment[61]. At least studies conducted in industrialized countries find that lower financial knowledge raises the risk of getting over-indebted. Lusardi and Tufano (2009) researched a national sample of Americans with very low levels of debt literacy, especially among women, elderly, and minorities, and a strong correlation between debt literacy and debt loads. Also Gerardi et al. (2010) found a significant negative correlation between numerical ability and default rates and hence found proof that in fact financial literacy has had its role in the subprime mortgage crisis in the U.S. Another study by the U.S. Government Accountability Office (GAO) (2010, 17) elucidates that people with limited language skills are more susceptible to „fraudulent and predatory practices" than people with better language skills. In the light of an earlier GAO study (2006, 46), which states that information about fees and rates, in this case for credit cards, are written in a complex manner and entail confusing and even conflicting information, consumers with low levels of financial literacy must have struggled greatly understanding this complex information. Other studies conducted in Australia further indicate that low levels of financial literacy are positively correlated with being victims of abusive lending practices and unawareness of recourse mechanisms and consumer protection regulations (Schetzer 2007, 51; see also T. Wilson, Howell, and Sheehan 2009). The studies cited

[61] This assumption makes clear how interconnected financial literacy and consumer protection regulations are. If loan prices are not disclosed in an understandable manner, even a household knowing its financial in- and outflows cannot judge whether it will be able to afford a certain product or not.

were all conducted in industrialized countries. Since there is evidence that financial literacy is low among the poor in developing countries, there is reason that financial literacy problems are even higher in developing than in industrialized countries.

In the following, I turn to the few studies conducted in developing countries. Miller et al. cite a 2008 internal working paper of the UK Department of International Development (DFID) by Godfrey, reporting that 60 percent of a survey sample in South Africa did not know what the term 'interest' meant (Miller et al. 2009, 4–5). Similar financial literacy problems are reported for Zambia, where more than nearly 70 percent of a survey sample had no understanding of basic financial products. There is also another interesting Indian case study, reporting that over 50 percent of self-employed workers in rural areas stack their cash at home (Shukla 2010, 83). This alone is not yet a proof of low financial literacy, however Miller et al. (2009, 4) discuss the risks of combining stacking cash at home with high-interest loan products. Enhancing financial literacy could minimize the resulting problems. The authors elaborate that this behavior (i.e. saving money at home and taking out high-interest loans) might peak in a worsening of the financial situation of a poor household. Keeping money at home means having no interest on savings and is further connected to two risks. First, savings are in danger of being stolen, and second, savings are likely to be spent on avoidable consumables. Hence, saving at home combined with high-interest loans might deteriorate the financial situations of poor households[62].

This brief review of empirical research reveals that illiteracy, first-time contact with financial products, difficulties in comprehension (e.g. lack of translation into indigenous languages or dialects), and differing cultural backgrounds partly contribute to whether a client slides into over-indebtedness or not. Therefore, it seems to be crucial to enhance the

[62] Nevertheless, we must not forget that, even formal MFIs might not all be allowed to take savings. So even if a household wanted to save formally, it could not. Also informal saving options, such as ROSCAS, might not be available in certain regions.

awareness and understanding of financial products. The main question is how to reduce these vulnerabilities by means of education?

As discussed above, financial literacy levels are generally low in developing countries. At the same time, struggles with the comprehension of financial concepts, budgeting, financial in- and outflows, savings, credit but also insurance and money transfer might prove to be highly individual. Basically, there is no one-size-fits-all approach to financial literacy issues. Keeping that in mind, I present three cases of how the problem of financial literacy can be tackled. *Case IV* is the financial literacy program of SEWA Bank operating in India. The *Case V* concerns a Kenyan educational soap opera that is the result of a collaboration between the public and private sector. Finally, *Case VI* introduces digital games, which aim to educate the player on the topic of financial services.

18.1 Case IV: The Financial Literacy Program of SEWA Bank

SEWA Bank is a MFI providing the BoP with microfinance services but also with financial education in Ahmedabad, India. They use a client-centered approach[63] in all their operations. This means that they assume that the provision of financial services should be oriented by an in-depth understanding of clients' needs (Kilara and Rhyne 2014, 1; Datar, Epstein, and Yuthas 2008, 40; Wardle 2014, 9). Only if the MFI has in-depth knowledge about its clients, can it improve their know-how about financial products.

In the following, I argue that collecting in-depth knowledge about a client is required on the one hand to figure out what level of financial literacy a certain client has and on the other to elaborate whether the client needs additional explanation or educational training regarding the products she purchases. I describe on what insights SEWA Bank's financial literacy program is based and what it entails. My description follows a presentation

[63] Please note that recently the term customer-centered or costumer-centricity is used interchangeably with the term client-centered.

held at the SEBI/OECD International Conference on Investor Education[64] (Vyas 2012). In order to set in place a financial literacy program SEWA Bank starts from one main assumption that the financial literacy program of SEWA Bank should account for the financial behavior of its clients. They presuppose that clients manage their money on a day-to-day basis and take impulsive decisions. Furthermore, SEWA Bank realized that most of their potential clients think that credit is the accurate product for all their life cycle events. Hence, it is key to create a program that focuses on building awareness about how to make a budget, plan for the future, what products there are, and what life cycle event matches the products. SEWA Bank uses different tools to first, assess their clients financial behavior and knowledge and second, to build awareness of how important financial planning and budgeting is.

Tools to collect in-depth household knowledge

SEWA Bank relies on in-depth knowledge about their clients' households. Therefore, local staff interviews households in order to find out more about the ways they manage their money. SEWA Bank applies different tools to do that. Due to the low literacy levels of households, the staff tries to use tools that are easy to understand and do not absolutely require the clients to read or write. The *first* tool is similar to the life cycle I introduced in Figure 1. SEWA Bank shows life cycle events with corresponding pictures, which aim to enhance comprehensibility, to the client and they discuss what situations she has already encountered and how she managed these situations. Did she make use of any microfinance product? And if so, did she use the accurate product, for example, a weather insurance to limit the damage in case of a flood? Discussing life cycle pictures is helpful to assess the understanding the client has about the risks she has faced or will face in the future and how likely these events are to happen. The *second* tool consists of a capital formation graph. Local staff asks the potential client to report her gains and declines in capital. On the bases of this data, the interviewer draws a life-graph displaying the capital formation of the client.

[64] If not indicated otherwise, the information provided is taken from this presentation.

In the exemplary graph (see Figure 5) one can see that while this woman was saving for old age needs, her husband died and that put a serious dent in the household's finances. A life-graph is not only helpful to see what lies behind but also, and this might go along with looking at possible life cycle events, seeing what may lie ahead. If we assumed that the business this woman opened in her early twenties still makes profit, the priority would probably be to create a plan to again start to save for old age needs. Also the focus would be to hedge potential risks, such as health problems, with insurance.

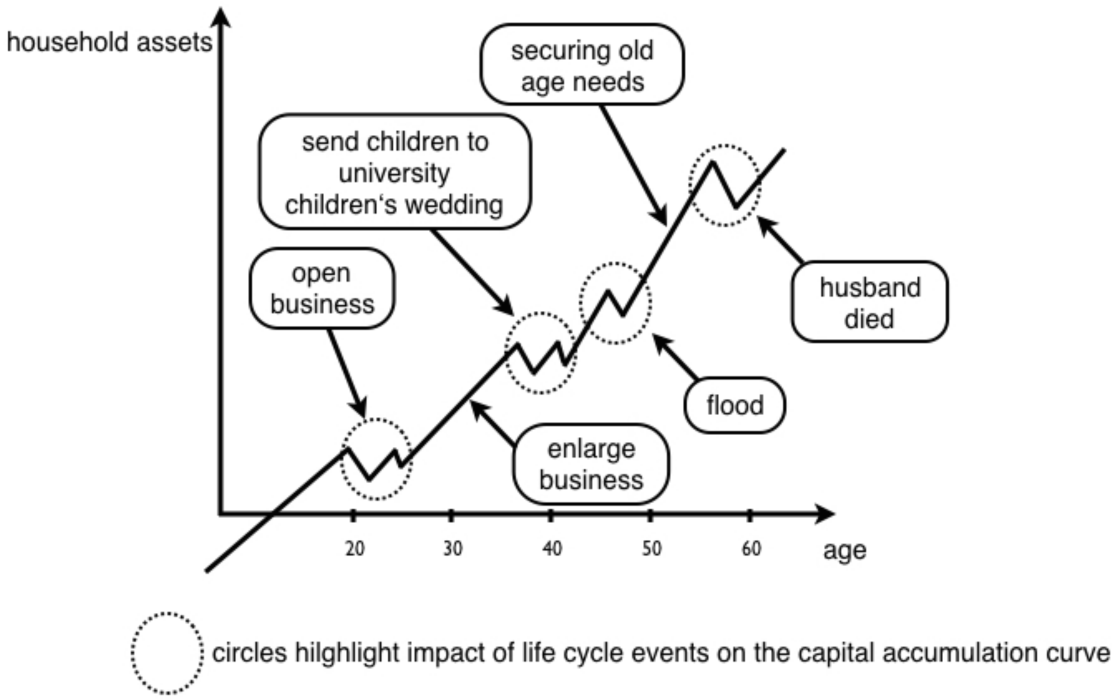

Figure 5: Capital Formation Life-Graph (own figure)

Drawing a life-graph is an easy economical way for SEWA Bank personnel to quickly comprehend the struggles the clients have encountered in their lives and how they have coped with these life situations so far. Clients' narratives give an idea about their financial knowledge and what financial products they have used in which life situation. Furthermore, in time a client's life-graph grows. Staff can continue to record the capital formation of the same household within the same life-graph over the time the household is with SEWA Bank. Life-graphs are an informative low-cost tool to keep track of the gains and declines of a household, and also help to assess in hindsight whether educational measures, such as training in budgeting, have proved fruitful.

SEWA Bank's Financial Literacy Program

SEWA Bank assumes that financial literacy programs should have three cornerstones: financial planning (1), savings (2) and understanding the products (3).

Building awareness regarding the importance of *financial planning* plays a key role in SEWA Bank's financial literacy endeavors. They normally illustrate this with the story of the ant and the grasshopper, which is a fable credited to Aesop.

> *In a field one summer's day a Grasshopper was hopping about, chirping and singing to its heart's content. An Ant passed by, bearing along with great toil an ear of corn he was taking to the nest.*
>
> *„Why not come and chat with me", said the Grasshopper, "instead of toiling and moiling in that way?"*
>
> *„I am helping to lay up food for the winter," said the Ant, „and recommend you to do the same."*
>
> *„Why bother about winter?" said the Grasshopper; „we have got plenty of food at present." But the Ant went on its way and continued its toil. When the winter came the Grasshopper had no food and found itself dying of hunger, while it saw the ants distributing every day corn and grain from the stores they had collected in the summer. Then the Grasshopper knew: It is best to prepare for the days of necessity. (Jacobs 1912, 86–87)*

With this short fable, SEWA Bank tries to show that shortsightedness in regard to financial planning can have large disadvantages and that it is key to plan ahead for hard times.

Also the role of *savings* is important in this regard. People are often not aware that if they only save a tiny amount every day, these tiny savings translate into a lump sum in some years. This cornerstone illustrates SEWA

Bank with posters showing pictures of a woman through her life. At the beginning she is young and does not need the extra money for medical bills but as she grows older these topics gain in importance and the posters intend to show this change in needs. Also they show their clients how savings can accumulate to lump sums over years by explaining and discussing savings plans with their clients. Furthermore, SEWA Bank educates clients to discern between avoidable and unavoidable expenses. Avoidable would be expenses for items that clients already have and of which they do not necessarily need an extra one. Also spending money on tobacco, alcohol or gambling is considered avoidable. Unavoidable, however, are expenses concerning the client's and her family's health or education. Again, SEWA Bank uses posters to illustrate the difference between avoidable and unavoidable expenses.

The last point is the *comprehension of products*. I will not describe all of SEWA Bank's products in detail; nevertheless I briefly touch upon loan, insurance and savings products. For the loan products, SEWA Bank focuses on explaining the difference between the productive and unproductive use of a loan and their loan terms and explain how interest is correctly calculated depending on whether the MFI uses flat or declining balance interest rates. In general, SEWA Bank's approach aims to prevent credit products being used for all kinds of purposes. As already discussed, credit might be used for its stipulated purpose (e.g. business) but might also be used for medical bills, tuition fees, or consumables. Educating clients about the purposes of its products, SEWA Bank wants to enhance the impact of their products. The explanation of insurance products is based on the aforementioned concept of the importance of planning ahead and being aware of potential risks that might occur in the future. In regard to savings, SEWA Bank focuses also on the concept of financial planning for old age needs. They, for example, explain the advantages of regular instead of irregular savings. Their financial literacy endeavors aim further to explain the linkage among different products. Going through possible life events with their clients and discussing and explaining, which products are suitable for what life situations, serves this purpose.

For all educational aims, SEWA Bank makes use of posters, narratives, comics, videos, role-plays, and calculations. Which method is used highly depends on the level of literacy and comprehension. The overall goal of the financial literacy endeavors of SEWA Bank is to help the clients select the financial products which match their life situation and understand the products they are purchasing. Furthermore, SEWA Bank gains valuable insights into how their clients manage their money and with an in-depth knowledge about them, they are able to design suitable new products and adapt existing ones. The program itself is diverse. SEWA Bank conducts camps and training for groups and offers individual counseling.

SEWA Bank evaluated that the educational tools helped the clients to plan ahead, spend their money more consciously and thereby reduce avoidable expenses, make use of savings and plan for old age needs. Purchases of insurance products increased. However, SEWA Bank also reports that changing the mindset of clients is a long-term venture. Despite the advantages SEWA Bank registered in providing microfinance clients with financial education, it is costly and might not be interesting for other MFIs to do. But the financial literacy program turned out to increase the sales of financial products and might help to render the program financially sustainable in the long run.

18.2 Case V: Makutano Junction: A Kenyan Soap Opera

Establishing financial literacy programs is not a strategy that is only pursued by MFIs. To the contrary, states and international- and transnational organizations establish financial literacy programs that have worldwide outreach. One specific example is the creation of a multi-media project that originated in Kenya but now is well known in many other countries: Makutano Junction. It is a Kenyan TV educational drama series that aims to entertain its audience but also disseminates useful information about health issues (e.g. malaria prophylaxis, HIV/AIDS), rights and responsibilities (e.g. women's rights awareness) and income generation (e.g. microcredit, how to operate a business, money management). Thereby the soap opera aims to build capacity for all kinds of life situations[65]. Makutano Junction episodes have over 6.5 million viewers in Kenya and other countries. To provide and cover important and pressing issues within the soap opera, the producers work closely together with NGOs, governments, bilateral donors, scholars and universities. For 2015 and 2016 the main topics were „tracking education of children, improving education in schools through teacher and parent participation, women's empowerment and agribusiness entrepreneurship" (MEDIAE.org 2015)[66].

Disseminating information via mass media is one possibility of reaching a large crowd and addressing several issues at the same time. There is no study measuring the isolated impact that financial literacy contents of Mukatano Junction have on viewers. However, there is evidence of the impact mass media has on personal behavior. One of the biggest and longest public health campaigns in Egypt, whose cornerstone was a soap

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[65] See http://www.makutanojunction.org.uk/the-soap.html [last accessed 16.02.2016] for character profiles and insights on the stories of the different families involved in the soap opera Makutano Junction.

[66] Interestingly, Mukatano Junction is recently used in other countries to be part of primary and secondary school's global learning curriculum. The subject of global learning includes topics, such as globalization, interconnections between people, cultures and countries around the world, social justice, poverty and human rights and aims to reduce prejudice towards and explore similarities with people living in developing countries (Makutano Junction 2014).

opera, enhanced the usage of oral rehydration therapy and diminished child mortality rates significantly among viewers (Abdullah 2004). Also other studies have shown that media may positively influence individual behavior and perceptions. Levy Paluck (2009) provides evidence concerning the reduction of intergroup prejudice and conflict by using a radio soap opera in Rwanda.

In regard to the impact of financial literacy content that is weaved into a soap opera there are two recent studies stating a significant positive relationship between treatment (i.e. seeing the content) and informed decision making (Berg and Zia 2013; Bernard et al. 2014). The *first* study by Berg and Zia (2013, 3) included financial education messages into a popular South African soap opera that is called 'Scandal!'. The main character slides into over-indebtedness and the story tells how she finds help to get out of her debt trap. For two months, the 'debt-trap' story lasts until she finds herself again in a better social and economic situation. The study includes three surveys; two surveys while the storyline is still playing out and one survey four months after the last show including the storyline was aired. Due to a symmetric encouragement design, the control group was incentivized to watch another soap opera airing at the same time as 'Scandal!' but containing no financial education messages and the treatment group was incentivized to watch 'Scandal!'. The results were quite astonishing and I present the two most significant results below. Besides the fact that 96 percent of the people surveyed actually watched the soap operas they were supposed to, the impact of financial education messages were very encouraging. The study showed „significant improvements in content specific financial knowledge […] and no improvements in knowledge of financial concepts that were external to the soap storyline" (Berg and Zia 2013, 4). Similarly positive were the results of the impact of the 'high interest charges and hidden cost' content that was central to the storyline. The likelihood of the treatment group to refrain from borrowing from private moneylenders instead of turning to formal lenders is 22 percent higher than before watching the show. The control group had an increase in the likelihood of only 13 percent. The storyline also featured a counselor of the

South African National Debt Association that helped the main character of the soap out of her debt trap. The counselor was only part of the cast for this particular storyline and disappeared again afterwards. One interesting insight of the survey was that although results kept being significant even for the last survey conducted four months after the ending of the storyline, there had been one exception. The counselor of the South African National Debt Association was only remembered as being part of the show and recalled as being employed by this association for the first two rounds of the survey. However, for follow-up survey, which was scheduled four months after, participants neither remembered the counselor nor the South African National Debt Association. Berg and Zia (2013, 24) attribute the lacking „emotional connections and familiarities" with the counselor and the association for forgetting about their purpose in contrast to characters that were present before and after the storyline played out. The *second* study by Bernard et al. (2014) presented similar findings for the case of rural Ethiopia. The treatment group watched a one-hour documentary featuring different life stories of individuals with similar backgrounds as the treatment group participants. The main topic of the documentary was how the subjects enhanced their economic status. The leading question was if the participants would take the narrators as role models and show a shift in their perception of the future (e.g. aspirations) or actual behavior. „We found that this intervention changed aspirations, as well as future-oriented behavior, namely about saving, use of credit and investment in education, six months after the screening" (Bernard et al. 2014, 3). The authors do not address the issue of emotional connections and familiarities, nevertheless I hypothesize that the length of the treatment in combination with the fact that the interview subjects came from a similar background as the treatment group, led to a lasting effect.

In conclusion, mass media is a powerful tool to convey educational messages; however, emotions and familiarity with radio or TV personalities may play a crucial role, whether the dissemination of these messages proves fruitful or not.

18.3 Case VI: The Gamification of Financial Literacy

The most recent innovation to enhance financial literacy is the so-called 'gamification'. Using game design techniques to promote services and make them more understandable has been designated as 'gamification' (Hamari 2013, 236). So the use of game mechanics in non-game contexts, such as health or finances, aims to incentivize individuals to learn something about these topics. Finances and financial services are seen as tedious and complicated to understand. Teaching the workings of services and how to make informed financial decisions via traditional teaching methods might be boring for many. However, people normally are interested in and have fun solving quizzes and playing games. By putting „game-like actions into everyday tasks" gamification enables MFIs to combine the interest of their clients to play games with imparting knowledge about finances in general and specific financial services (York 2015). Two examples of games that aim to improve the financial literacy of people are:

I. *'Thrive 'n' Shine'* is a mobile app game where the player can choose an avatar with whom she can pursue different goals and is independent regarding the choice of financial services she might want to use. The player has to fulfill specific tasks, so-called 'quests'. If the player manages to accomplish a certain number of quests, she is able to access the next level, which builds on what she has learned so far. The higher the level, the more freedom she will attain to choose from different services and the more complex the quests will get. One of the main aims of Thrive 'n' Shine is to teach the importance of savings and seeing the value of saving money to be able to save up for old age needs or use savings for unavoidable expenses (York 2015).

II. *Financial Football* is a game that might be played on the computer or over smart phones and tablets. It is a joint venture of Visa and the U.S. National Football League (NFL). Players may choose the team they want to play with and the opponent team. Levels of difficulty range from ages 11-14, ages 14-18 and ages 18+. If the multiple-choice questions, which the player has to answer before every move, are answered correctly the player can choose from different football formations and is able to move down the field and make touchdowns. The player can either play in single player or head to head mode (Practical Money Skills for Life 2015a). There are also similar games featuring other sports, such as soccer (Practical Money Skills for Life 2015b). Questions range from „If a girl purchases 10 apps a month at $4.95 each, how much per month is she paying total?" (ages 11-14), „How long does negative financial information (excluding bankruptcy) stay on your credit report" (ages 14-18), to „What is debt consolidation?" (ages 18+) (Practical Money Skills for Life 2015b).

Gamification, as it is known in industrialized countries, might not be very helpful in enhancing the financial literacy of microfinance clients in developing countries at the moment. Evidence shows that internet access is strongly linked to income per capita and therefore poorer households are often not able to afford internet access or a smart phone (Poushter et al. 2015, 8). Nevertheless, people are more and more using either cell- or smart phones and MFIs find ways of using the phones to educate customers about products or general financial topics (Poushter et al. 2015, 17). Absa, a South African bank, realized that with the Shesha Game. This game is one example of how games working on cell phones can be used in order to enhance the usage of a service and to improve the understanding of financial concepts.

III. Absa's *Shesha Game* is a game that can be played on cell phones. Although 50 percent of Absa's low-income clients enabled mobile banking (mainly for checking account balances) over their cell phones, they did not use this service. Instead, clients undertook long and costly journeys to get to the regional offices to see what their balance was. Absa developed a Shesha Game, Shesha means quick-quick. Absa sent text messages to the clients inviting them to play Shesha. *First*, the client had to answer questions about her finances with the possibility of winning airtime. *Second*, the client had to use her newly gained knowledge and check her account balance. For the second part of the game, clients could win a cash prize. Absa registered an increase in „balance check activity" of the clients participating in the game by 54 percent after two months and by 61 percent after six months (Coetzee 2015).

18.4 Interim Conclusion – Financial Literacy Endeavors

Financial literacy of the BoP is low. I shed light on three different possibilities to educate the BoP on financial services and thus reduce the risks of sliding into over-indebtedness. *Case IV* served to discuss how MFIs could help their clients better understand the specifics of their products. I showed that, with low capital expenditure, MFIs can gain in-depth knowledge about their clients' and may take according measures to inform them about products. *Case V* addressed Mukatano Junction, a Kenyan soap opera, which is concerned with weaving problems such as money management and health issues into the storyline and thereby educate its viewers. *Case VI* talked about gamification and how digital games and applications can be used in microfinance. Although the use of smart phones and computers is still minimal among the BoP, most microfinance clients own cell phones, which MFIs can use to help clients understand financial products they offer. I gave two examples of games that can be played on computers and smart phones and I presented the example of Absa's Shesha Game, which was developed for use on cell phones.

Educating microfinance clients can be achieved with different strategies. In this chapter, I showed how MFIs singlehandedly or in partnership with private actors or state departments aim to improve the financial literacy of the BoP. Although MFIs might not want to also provide financial education to their clients in the sense of 'microfinance plus' due to the therewith connected costs, I showed with the case of SEWA Bank that enhancing financial literacy could come at a relatively low cost for MFIs, helps to gain in-depth knowledge of the client base to detect risks and locate where there is need for improvement, and may even increase the uptake of certain products adding to the financial sustainability of the MFI itself.

In the following chapters, I elaborate on the third pillar of the responsible microfinance framework, which concerns soft law standards. Analyzing four cases of soft law standards that have a connection to client protection and social performance in microfinance, I show how applicable these standards are to the responsible microfinance framework and whether and to what extent these standards are established in the public interest. The leading question of the following chapters is which standards are best applicable to microfinance and entail the qualities of a standard, which was established in the interest of the thereof affected. In doing so, I evaluate the four different standards against the common interest theory presented by Mattli and Woods (2009).

19 Pillar Three: Soft Law Standards

Both transnational and international standards usually show characteristics of soft law. They are voluntary and represent best practices (Mattli and Woods 2009, 3). On the one hand soft law standards aim to be „technically competent standards" that help coordinate and define concepts which are key in specific economic domains (Richardson and Eberlein 2011, 217). On the other hand, and due to the fact that soft law standard-setting institutions operate outside the sovereignty of states, they are presented with the challenge of how to best establish standards that are nevertheless legitimate and even enforceable (Richardson and Eberlein 2011, 217). This chapter about soft law standards addresses the common interest regulation theory, which aims to understand why some transnational and international regulations represent narrow interest as a consequence of regulatory capture, while others seem to represent the public interest. These theoretical deliberations preceding the four cases I present, addresses the problem of how to best establish standards which address key issues in a specific economic domain and are in the common interest and therefore pursue legitimacy and strive for better enforceability. After having introduced the analytical framework of the common interest theory, I conduct the analysis of the four cases and categorize them within the framework.

Nye and Keohane (1971, 331) define transnational relations as „contacts, coalitions, and interaction across state boundaries that are not controlled by the central foreign policy organs of governments". Transnational relations that are institutionalized and generate standards through certain procedures are called trisectoral policy networks (Risse 2004, 303), private regulations (Cafaggi 2012; Scott, Cafaggi, and Seden 2011), transnational regulatory standard-setting institutions (Abbott and Snidal 2009b; Abbott and Snidal 2009a), private governance (Lipschutz and Rowe 2005; Pattberg 2005), non-state market driven governance (Cashore 2002), and network governance (Carllson and Sandström 2008). Normally, transnational bodies are multi-stakeholder institutions[67] including market, government and civil society actors. In contrast, international bodies are traditionally state-centered institutions that consist of „formal, continuous structures established by agreement between members from two or more sovereign states with the aim of pursuing the common interest of membership" (Archer 2001, 33).

In regard to both, transnational and international standard-setting, scholars repeatedly have addressed the problem of participation. Dahl (1999) argues, for example, that IOs are non-democratic. In IOs

> *the opportunities available to the ordinary citizen to participate effectively in the decision of a world government would diminish to the vanishing point (Dahl 1999: 22). […] If it is difficult enough for ordinary citizens to exercise much influence over the decisions about foreign affairs in their own countries, should we not conclude that the obstacles will be far greater in international organizations (Dahl 1999, 32)?*

The 'participation gap' has been identified and repeatedly addressed in publications of the late 1990s (Kaul, Grunberg, and Stern 1999; Reinicke et al. 2000; Reinicke 1998) that give possible answers to Dahl's critique. Kaul, Grunberg, and Stern (1999, xxix–xxxii) for example discuss the role of participation in the realm of the use and management of public goods. The authors advocate a novel form of 'tripartism'[68]. The claim of improving political participation of and deliberation among the stakeholders in regard to a certain political issue materializes within the theories of responsive regulation (Ayres and Braithwaite 1992), hybrid governance (Bäckstrand 2006a, 471), proceduralization (Black 2000), civil regulation (D. Vogel 2009), and common interest regulation (Mattli and Woods 2009; Büthe and

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[67] Institutions are here defined as the „entities featuring continuity, longevity, and stable contexts for action" (Goodin, paraphrased in Dryzek 1996, 103).

[68] The form of tripartism Kaul, Grunberg, and Stern propose finds its origins in the theory of social corporatism, which attempts to explain that social peace is enabled by giving a voice to different actors: The private sector, labor unions and governments cooperating as 'social partners' (Katzenstein 1984, 27). Although Ottaway (2001) has deliberated a reinvention of corporatism on the transnational and international level, her idea was never reconsidered and other theories focusing on the participatory and deliberative elements to explain the successful cooperation between the private and public sector, such as the theories of hybrid governance or common interest regulation, have been given prominence.

Mattli 2011). „The dominant call is to develop procedures and institutional structures that will enhance deliberation and enable participation" (Black 2000, 597–598). All of the theories mentioned above allow for and encourage the participation of public and private stakeholders and especially emphasize the role of deliberation in order to give an answer to the critique of decision-making processes being illegitimate on the international and transnational level. Dahl's critique is further challenged by practical evidence. The multi-stakeholder approach of the UN is pursued ever since the Rio de Janeiro 'Earth Summit' in 1992. These summits „have emerged as an important arena in which experiments with new forms of stakeholder participation have gained prominence" (Bäckstrand 2006b, 469). For example Article 71 of the UN Charter stipulates that the Economic and Social Council (ECOSOC) may consult NGOs on issues falling in ECOSOC's competencies (United Nations 1945).

According to Dahl (1999, 33) democratic elements are very unlikely to occur in „bureaucratic bargaining systems". „Even if the threshold is pretty hazy, I want to argue that international systems will lie below any reasonable threshold of democracy" (Dahl 1999, 22). Rightfully, Dahl claims that ceteris paribus possibilities to partake in decision-making in small democracies are greater than in larger democracies, let alone IOs. However, in a highly politicized sphere dominated by bargaining national states, it was, for example, possible for the first time that a „normative text [the UN Guiding Principles on Business and Human Rights] that governments did not negotiate themselves" was approved (Ruggie 2013, xx). But most importantly and also for the first time, intensive and myriad consultations preceded this norm-setting process. Ruggie and his team of researchers created a precedent making use of this approach.

Arguing that the example of how the Guiding Principles on Business and Human Rights came about would negate Dahl's claim of international IOs being non-democratic would stretch a point. Nevertheless, I would like to accentuate the fact that the mandate of operationalizing and endorsing the 'Protect, Respect and Remedy framework', which is discussed in more detail in Chapter 19.3, did include intense consultations with a wide array of stakeholders: experts, affected individuals, companies, NGOs, workers' organizations and so on and so forth (Ruggie 2013, xx). Theories, such as the common interest regulation, try to explain why it is important to include a diverse set of stakeholders into standard-setting processes to enhance legitimacy and potential enforceability in the transnational and international realm.

In the following, I *first* elaborate on the common interest[69] regulation theory Mattli and Woods (2009) present. They define common interest regulation as a proceduralist concept: A regulation is in the „public interest if it is arrived at through a deliberative process that allows everyone likely to be affected by it to have a voice in its formation" (Mattli and Woods 2009, 13–14). *Second*, I evaluate the four hard cases, which are either directly connected to soft law client protection and social performance standards in microfinance or are addressing the issue of general corporate responsibility towards consumers.

19.1 The Analytical Framework of Common Interest Regulation

Mattli and Woods (2009, 4) present a theoretical framework that tries to answer the question why some transnational and international regulations „entrench narrow interests" as a consequence of regulatory capture, while others realize „broader public purposes" (i.e. common interest). 'Regulatory capture' „is the control of the regulatory process by those whom it is supposed to regulate or by a narrow subset of those affected by regulation, with the consequence that regulatory outcomes favor the narrow 'few' at the expenses of society as a whole" (Mattli and Woods 2009, 12). Defining 'public interest' is more complicated since there are differing definitions (Downs 1962, 11; Schubert 1960). Mattli and Woods (2009, 13–14) attribute the different uses of 'the public interest' to three schools of thought: *Idealists* define public interest as the line of action which serves

[69] Common interest is hereafter used interchangeably with public interest.

society as a whole. In order to do that, governments apply an „absolute standard of values", such as welfare economics use standards of economic efficiency but these do not have to meet the actual desires of society (Downs 1962, 11). *Rejectionists* believe that there is no public interest, due to the fact that they presuppose only individual actors and interest groups; however, neither society nor the community as a whole partake. The *proceduralists* start from the assumption that public interest is connected to the regulatory process itself. So „the public interest is defined by the interest process" (Cochran 1974, 342). This interest process has to be deliberate, so all the parties that are likely to be affected by a certain regulation have the opportunity to voice their views and thereby influence its formation. The acceptance of a regulatory outcome is more likely if the stakeholders see the procedures as suitable to provide them with the ability to voice their opinion, even if the regulation does not turn out in their favor in the end (Mattli and Woods 2009, 14; Esty 2006, 1511).

Mattli and Woods take on the proceduralists view but they refine the analytical framework further. They argue that welfare economists, who are here subsumed under the idealist school taking economic efficiency as a benchmark for regulating, wrongfully assume that the state will always effectively eliminate deficiencies through regulations. Proceduralists on the other hand account for the ever-changing institutional context within which regulations are established. They propose a thorough assessment of the institutional context and the procedures connected therewith that establish regulations in order to see to what extent the public interest is reflected. However, proceduralists rely on the hypothesis that putting due process institutions into being necessarily eventuates in regulations that reflect the public interest. Mattli and Woods (2009, 15) claim that „proper institutional supply needs to be met by robust societal demand (from the public and private sectors alike) for common interest regulation to emerge".

As Mattli and Woods criticize the proceduralist approach, public interest regulations will not automatically be triggered by institutional supply including due process channels. People might be uninformed about regulations that affect them regardless of them being greatly or only faintly impacted. In comparison to non-state actors, which gained importance and power in shaping transnational and international standards in the past decades, individual members of society are likely to get lost and miss the chance to voice their opinions. This, however, would miss the mark of public interest regulations. Mattli and Woods (2009, 15) fear that without a „broad societal demand, industry and other concentrated groups targeted for regulation may be the most frequent users of due process channels". Hence, regulatory outcomes cannot only be considered in the public interest when the institutional possibilities of participating in the regulatory process are extensive. There has to be also a broad societal demand for regulations. Mattli and Woods (2009, 16) understand societal demand for establishing regulations or changing regulations as a function of information, interests and ideas. Their analytical framework accounts thus for the gap in the proceduralists' approach and includes not only an institutional supply but also a societal demand dimension.

Mattli and Woods' (2009, 12) analytical framework explains the differing outcomes of „the politics of global regulation […] ranging from pure capture regulation to common interest regulation". They conceptualize 'institutional supply' as having two possible characteristics: limited or extensive. The same applies for the 'demand side' of a regulation, which can either be limited and narrow or broad and sustained. As illustrated in Figure 6, depending on the combination, regulations are either pure capture regulations (C), de facto capture regulations (D), capture regulations but with concessions and compromises (A), or common interest regulations (B).

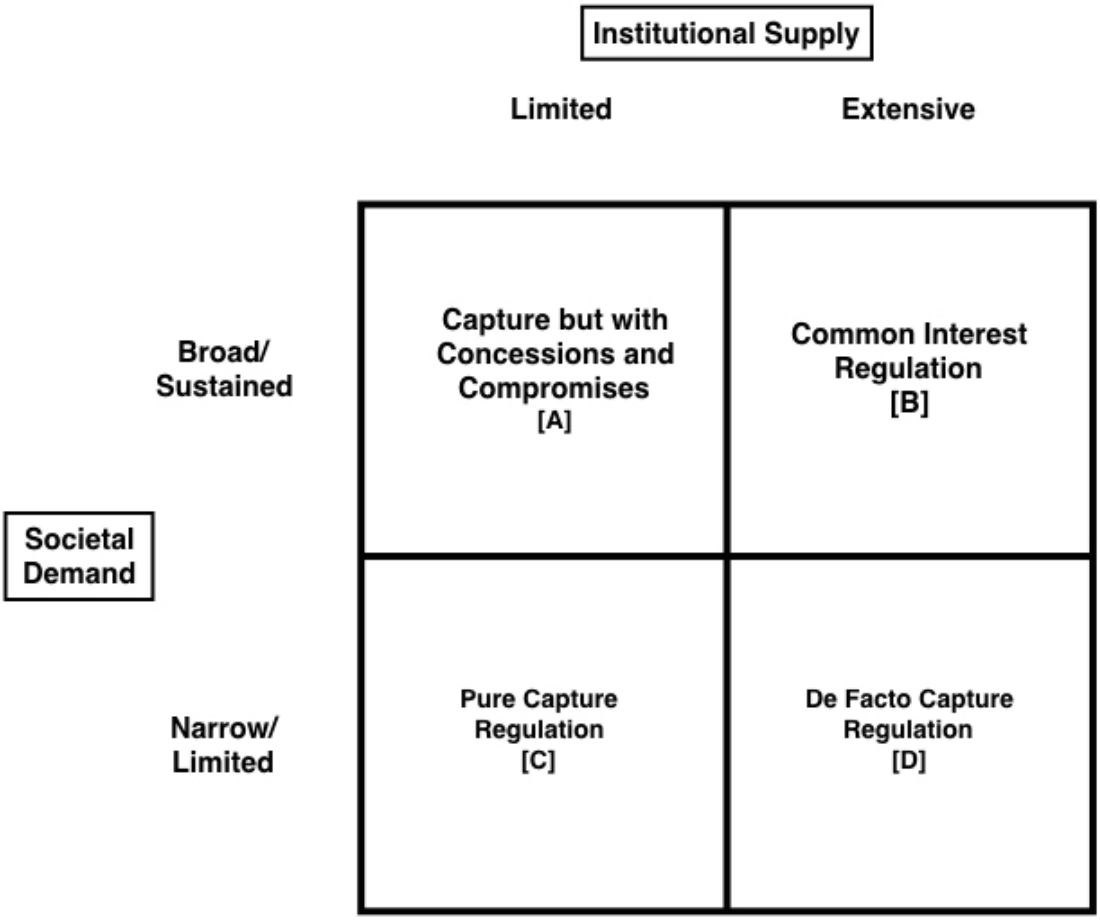

Figure 6: Regulatory Outcomes (adapted from Mattli and Woods 2009, 16)

Let me further illustrate the possible regulatory outcomes in their analytical framework. Information asymmetries and different levels in financial capital and expert knowledge among stakeholders may result in *de facto capture* regulation, even if all parties had access to influence the formation of a regulation. Powerful non-state actors are equipped with the necessary resources, capacity and expertise to bias the regulation in their favor and thereby further their narrow interest ('the haves') to the disadvantage of the public broader interests ('the have-nots'). Although originally the institutional design may have aimed to privilege the broader interests, it resulted in privileging the narrow interest of the biggest players (see D, Figure 6). *Pure capture regulation* is attained if institutional supply and demand is limited. The most powerful stakeholders will be able to push their interests through and the institutional context, which is closed and exclusive, will facilitate total capture (see C, Figure 6). The opposite case, where the institutional supply is extensive and the societal demand is broadly supported, creates *common interest regulation* (see B, Figure 6). Nevertheless, even with the broadest demand for changing the regulatory status quo, if the possibilities to participate in the formation of the regulation are limited, the most powerful players will, ideally, account for the public interest in the form of concessions and compromises. This is however only the case if the societal demand is demonstrated in such a way that naming and shaming of particular actors, or other pinpricking strategies, result in forcing the more powerful players to make compromises and concessions in the regulatory formation process (see A, Figure 6).

Common interest regulation theory could make a valuable contribution in evaluating the four practical cases of transnational and international soft law standards and help assess in which category they fall. The analytical framework presented hereinafter provides an instrument to evaluate whether the four soft law standards are in the public interest or not. The proposed explaining variables in the analytical framework of common interest regulation theory are the extent of institutional supply and societal demand.

19.1.1 Institutional Supply-Side Conditions

Regulatory entities differ greatly in regard to their transparency, openness, participation and accountability. Mattli and Woods (2009) argue that only if deliberative mechanisms are included in the regulatory process, which passes five stages (i.e. agenda-setting, negotiation of standards, implementation monitoring, enforcement) (Abbott and Snidal 2009b, 46), is the regulation legitimate and all stakeholders

> *accept outcomes as being in the public interest as long as they feel that existing procedures of consultation and involvement offer them a fair chance to put their views across and influence regulation in their own favor, even if they are not always successful. Proper due process mechanisms are said to produce*

regulation most likely to benefit most in society. (Mattli and Woods 2009, 14)

Acceptance and acceptability of a current social and political order is how legitimacy is conceived here (Hurd 1999, 381). This conception of legitimacy includes an „empirical measure of legitimacy (acceptance of a rule or institution as authoritative) and a normative argument concerning whether the authority possesses legitimacy (providing reasons that justify it)" (Bernstein 2005, 142).

One way of political science and theory to think about legitimacy is through the concepts of input- throughput- and output legitimacy. The normative concepts of input-, throughput- and output legitimacy originated in the works of Scharpf (1970; 1997; 1999) and capture „Lincoln's famous dictum about democracy requiring government by the people (political participation), of the people (citizen representation) and for the people (governing effectiveness)" (Schmidt 2013, 4). The conception of legitimacy as input-, throughput- and output is comprehensive but yet demanding when thinking about applying this framework in the international let alone the transnational sphere of standard-setting institutions. Rules are drafted, implemented, monitored, and enforced within the institutional structure that is charged with forming the regulation. As presented in Figure 6 the institutional supply may be extensive and therefore characterized by „open forums, proper due process, multiple access points, and oversight mechanisms", or it might be limited and therefore possibilities of participating in regulatory formation is „exclusive, closed, and secretive" (Mattli and Woods 2009, 17).

As addressed before, international and transnational rule making is described as increasingly opening-up to and already applying various forms of participation from non-state actors, such as NGOs, companies, and individuals. Mattli and Woods (2009, 19) evaluate the power of the formation of regulations by including many stakeholders as potentially strong. However, they assume the positive evaluation of rule-making on an international level, as especially brought forward by legal scholars, as overstated[70]. The mere provision of institutionalized processes to impact rule-making does not automatically translate into a demand to use these participation channels. The authors argue that supplying deliberative mechanisms within a rule-making process is necessary yet not sufficient to assume that the regulatory outcome reflects common interest. They present four weaknesses of an analytical framework, which only focuses on institutional supply of participatory channels. *First*, including non-state actors in rule-making processes may be beneficial for the regulation to be in the public interest but is not a guarantor for it. Due to asymmetries in resources and information, big players may be able to bias regulations in their favor and therefore enhance capture. *Second*, frequently only the rule-making process is open for many; however, how to manage implementation and enforcement is often the task of an exclusive few. Thus, the regulatory process is still vulnerable to capture. *Third*, in most cases of international and transnational forums we lack an overarching sovereign institution. National systems have legislatives, and other actors (e.g. review boards, inspectors, whistle blowers), which hold regulators responsible for their conduct. This problem is not overly severe in IOs, such as the World Trade Organization (WTO), the World Bank or the International Monetary Fund (IMF), where organizations are mostly controlled by states and therefore can be held responsible for their conduct. The picture is different for transnational organizations, which are composed by mostly non-state actors. Although many stakeholders may be able to participate in the rule-making process, this is usually not the case for the implementation and the enforcement phase, which is usually led by a club of actors. Actors that are engaged with transnational regulatory processes are not subject to many constraints in the implementation and enforcement phase due to the emphasis on participation in the rule-making process (see Table 3 in Grant and Keohane 2005, 40). These institutions traditionally lack an oversight body, which holds the key actors in the implementation and enforcement

[70] Kingsbury et al. (2005, 4), for example, describe the procedure of including open forums and the like in the regulatory formation process as a general trend, however do not account for capture that might be prevailing despite the existence of possibilities to participate.

phase responsible for their conduct. *Fourth* and as mentioned above, the mere existence of an institutional context, which allows for participation, does not automatically translate into great demand from society to voice there opinions through these channels. Providing the institutional context to enable broad access during the regulatory processes (i.e. agenda-setting, implementation, monitoring, enforcement) is a necessary condition to render common interest regulation attainable. However, also demand-side conditions have to be met in order to empower the public to actually participate.

19.1.2 Societal Demand-Side Conditions

Why are demand-side conditions important for international and transnational regulations to be in the common interest? Matters which are regulated on a global level are further away from the public eye than national ones. Gathering information about planned regulations and shortcomings of existing regulations is costly, and without opportune information stakeholders might surrender first-mover advantages to a comparatively more powerful stakeholder (Mattli and Büthe 2003, 4). In order to have a significant impact on the regulatory process, actors must be equipped with know-how and financial resources, which are usually the privileges of the more powerful players (Mattli and Büthe 2005, 242). This results in a few having the power to collect the information needed and the resources to induce regulatory change in their favor, irrespective of how the institutional supply-side is positioned (i.e limited or extensive).

How then have the demand-side conditions to be set in order to facilitate effective participation of a broad range of societal groups and enhance their willingness to do so? What variables explain the variation from a narrow and limited to a broad and sustained demand for regulatory change in society? Mattli and Woods present three demand-side conditions that have to be fulfilled: information, interests, and ideas.

Information

The dissemination of information is able to provide society with knowledge about the costs of regulatory capture and motivate societal groups to act for change (Mattli and Woods 2009, 21). In times of crises, scandal or environmental disasters, information is key to detect the „extent of failings, abuse, or incompetence of regulators" (Mattli and Woods 2009, 22). Mass media and the internet may boost these demonstration effects further and may show the public „negative externalities of no or poor regulation" and motivate change (Mattli and Woods 2009, 4). By revealing the cost of capture to the broader public, information triggers a demand for regulatory change in society, whereas the demand for change rises with the severity of the externality (Mattli and Woods 2009, 26). Information is therefore the first indicator reducing the vulnerability to capture and enabling common interest regulation.

Interest

Converging interests play a vital role in regulatory processes. If regulatory failure occurs, the public requires pro-change forces that conflate their interests (Mattli and Woods 2009, 21). This is especially important because to sustainably impact and change regulation, the so-called entrepreneurs of regulatory change have to be active throughout the whole regulatory processes, which is lengthy and includes agenda-setting, negotiating standards, and implementing, monitoring and enforcing them (Mattli and Woods 2009, 26, 28). Entrepreneurs for regulatory change might be of private or public character. Mattli and Woods differentiate between nongovernmental, public official and private sector entrepreneurs (2009, 28). Nongovernmental entrepreneurs traditionally have the role of watchdogs and are engaged in pointing a finger at regulatory failure and mobilizing support in the formation of new regulation, which privileges the public interest (Vogel 2009, 153). However, NGOs need allies to effectively urge regulatory change, since they often lack financial resources to change regulations single handedly (Mattli and Woods 2009, 29). Although public officials, ranging from legislators to experts of special agencies, are seen as being vulnerable to capture the authors argue that if officials use their authority to further public interest, as for example John Ruggie as a UN special representative did in the case of the UN Guiding Principles on Business and Human Rights, they may play a crucial role in impacting regulations into the common interest direction (Mattli and Woods 2009, 32). There are at least four types of private sector entrepreneurs, which all have different motivations to engage in changing regulations. Corporate consumers buy regulated goods and services. If these goods and services are subject to capture regulation, corporate consumers are put at a disadvantage and will be motivated to change these regulations. Corporate newcomers often face hurdles to enter markets which are controlled by already established companies. Newcomers have therefore an incentive to oppose the regulatory status quo. Corporations at risk are also an important actor when it comes to regulatory change. Companies facing financial difficulties have an extra strong motivation to induce regulatory change if this change ensures economic survival. Further, corporate leveler of the playing field suffer from constraints because they are subject to stricter regulations than other players elsewhere. These companies have an incentive to change regulation in such a way that all corporations should abide by these rules. This especially applies to companies operating on a global scale. European corporations, for example, face stricter rules in regard to environmental improvement than their Asian or American counterparts (Mattli and Woods 2009, 28–35). The entrepreneurs of regulatory change introduced above have special knowledge about their field of operation and how regulation should be adapted in this regard. Private-sector but also specialized official actors have the potential to change regulation in the public interest.

Ideas

Walking in the same direction concerning the goals of regulatory change and shared ideas are key. Demonstration effects question prevailing ideas, values and ideologies. They challenge the status quo and the legitimacy of existing regulations, which opens up room for other ideas to arise (Mattli and Woods 2009, 36–37). Shared sets of ideas ideally provide a common ground to effectively urge change and act as glue to build coalitions between different entrepreneurs of regulatory change (Goldstein and Keohane 1993, 12, 17; Mattli and Woods 2009, 21). Mattli and Woods conclude that

> *the set of ideas most likely to triumph after a crisis is not only that which best expresses the interest of powerful entrepreneurs and a coalition to form, but that which fits most easily into existing and not discredited institutions and mechanisms, representing the smallest step into the unknown. (Mattli and Woods 2009, 39)*

In the following, I present four hard cases, which are concerned with corporate responsibility in general, and client protection and social performance in microfinance. All of the cases include at least some possibilities for stakeholder participation. These cases contrast the viewpoints of skeptics bringing forward the argument of a legitimacy deficit in international and transnational organizations. Two of them fall into the category of standards set by state-centered bodies with allowance to consult with a diverse set of stakeholders (Case VII and VIII). The other two cases presented are hard cases due to their specificity to setting exclusively client protection and social performance standards in microfinance with the help of extensive stakeholder involvement (Case IX and X). The scope of this research project and the problem of availability of data does not allow for a conclusive discussion of the four cases, however the cases will be discussed in as much detail as possible. If there was a lack of data concerning certain points, I indicate them as such. The analysis of the institutional supply-side conditions are summarized in Chapter 19.7 (Tables 1 to 4) and the results from the societal demand-side conditions analysis are presented in Chapter 19.8. The categorization within the analytical framework and the discussion of the applicability of the cases to the multi-stakeholder framework of responsible microfinance are discussed in Chapter 19.9 and Chapter 19.10.

19.2 Case VII: UN Guidelines for Consumer Protection: Financial Services Chapter

In 1981, ECOSOC passed a resolution which requested the UN Secretary-General to work towards establishing a set of consumer protection guidelines addressed to member countries. The resolution requested the Secretary-General to especially factor in the needs of the developing countries. ECOSOC was presented with a first set of consumer protection guidelines in 1983 and they were adopted by a consensus resolution of the UN General Assembly in 1985 (UN General Assembly 1985). The guidelines were first revised in 1999 when a new chapter on sustainable consumption was added (ECOSOC 1999). The guidelines include building blocks of consumer protection systems which further economic, environmental and social goals, such as protecting consumers from malpractice and hazardous products, promoting sustainable consumption and securing access to basic needs products (e.g. water, food, health services), and accessing remedies (e.g. dispute resolution, redress) (UNDESA 2003). The 1999 set of guidelines went through another critical phase of revision from 2012 onwards.

The revised guidelines of 1999 lacked factoring in the newest insights about consumer protection and did not mirror the current situation of consumer protection in UN member countries (UNCTAD 2012). Starting in 2012 member countries, NGOs, and advocacy organizations were asked to hand in inputs and comments on how to revise the guidelines. The document inviting member states and international organizations to comment on the existing UN guidelines for Consumer Protection states:

> *In order for these Guidelines to continue to provide an important framework, a number of areas have been identified for their improvement. Firstly, […] their content does not reflect the issues covered in […] contemporary consumer protection laws and policies. Secondly, their scope of application does not correspond with the usual powers of modern consumer protection authorities. Thirdly, the Guidelines are not backed by a state-of-the-art*

compilation of the best practices and common trends in the field of consumer protection. (UNCTAD 2012, 1)

In 2013, the United Nations Conference on Trade and Development (UNCTAD) issued a draft including all feedbacks[71] from member countries, NGOs and international consumer organizations. Out of 47, 12 contributions were from consumer organizations and NGOs, the others were either from states or state-centered institutions (i.e. OECD, EU). Several expert groups were formed and meetings were conducted to determine key areas that should be included into the revised principles (i.e. e-commerce, financial services, data protection) or that needed further consideration before including them (i.e. data protection, misleading advertising, energy, cross-border trade, transport, universal services, access to knowledge, tourism, class actions, and housing) (UNCTAD 2014, 1). The second expert group meeting held in July 2013, for example, focused on implementation issues and argued unanimously in favor of international implementation and monitoring mechanisms.

All experts agree that there is a need for international implementation or monitoring mechanisms. Following proposals expressed earlier, the questionnaire proposed a hypothetical UN Commission or the creation of an intergovernmental structure on consumer protection within UNCTAD.

[…] Regardless of the institutional structure, experts called for the creation of an international body to undertake the following activities: reports on consumer rights; consumer law and policy reforms; reports on national compliance with UNGCP; exchange of best practices and common actions; and development of common policies. According to some experts, this body should be independent, concerned solely with consumer issues, and proactive in policy recommendations. (UNCTAD 2015a, §84)

Furthermore, four working groups with the following national leaders have been formed: e-commerce (France), financial services (Malaysia), other

[71] For a complete list of the contributions, please see http://unctad.org/en/Pages/DITC/CompetitionLaw/UN-Guidelines-on-Consumer-Protection.aspx [last accessed 12.12.2015].

issues (Brazil and Germany) and Implementation of the principles (Gabon) have been formed (UNCTAD 2015a, 5).

As of the beginning of July 2015, the UN General Assembly adopted the revised Guidelines for Consumer Protection, the main adjustments being two new chapters addressing topics of e-commerce (chapter I.) and financial services (chapter J.) and the creation of an intergovernmental group of experts on Consumer Protection Law and Policy[72] (UN General Assembly 2015, §44, §97). How the feedback of member states, IOs and NGOs influenced the 'tone' and vigor of the document becomes visible in a document of UNCTAD highlighting the adjustments before and after the revision (UNCTAD 2015b). This vigor finds, for example, expression in Article 66 of the financial services chapter J. that is of special interest here. Including the corrections, it reads as follows: „Member States should ~~[work towards]~~ establish~~[ing]~~ or encourage~~[ing]~~, as appropriate". The main cornerstones of the financial services chapter (see Art. 66 to 68) are that member states should establish or encourage

> *66. (a) financial consumer protection regulatory and enforcement policies;*
>
> *(b) oversight bodies with the necessary authority and resources to carry out their mission […];*
>
> *(e) fair treatment and proper disclosure [including all fees], ensuring that financial institutions are also responsible and accountable for the actions of their authorized agents. […];*
>
> *(f) responsible business conduct by financial services providers and authorized agents, including responsible lending and the sale of products that are suitable to the consumer's needs and means;*
>
> *(g) appropriate controls to protect consumer financial data, including from fraud and abuse […];*
>
> *67. Member States should adopt measures to reinforce and integrate consumer policies concerning financial inclusion,*

[72] Despite two NGOs voted against establishing an intergovernmental structure and instead favored a UN commission in the expert group meeting in July 2013, the UN General Assembly Resolution featured an intergovernmental body of experts (UNCTAD 2015a, §84).

financial education and the protection of consumers in accessing and using financial services;

68. Member States may wish to consider relevant international guidelines and standards on financial services and their revisions thereon, and, where appropriate, adapt those guidelines and standards […], as well as collaborate with other Member States in their implementation across borders. (UNCTAD 2015b, Art. 66–68)

While the Guidelines for Consumer Protection are not obligatory, they have marked a milestone as a normative and soft law document to further and enhance consumer protection on an international level. Furthermore and despite its soft law character, the UN Guidelines for Consumer Protection significantly influenced consumer protection policies in numerous countries (ECOSOC 1995; see also UN Secretary-General 1993).

The UN Guidelines for Consumer Protection do not only address the rights consumers have but furthermore emphasize the duty member states have to fulfill, establish and encourage the claims and policy propositions featured in these consumer protection guidelines (see also Benöhr 2013, 103). This shows the emphasis the UNCTAD wanted to convey with their revision of the guidelines and the amended wording mentioned above. Nevertheless, the intergovernmental expert group on Consumer Protection Law and Policy and its subsidiary institutions mandated to help the endorsement of the guidelines are not allowed to, in any way, „pass judgment on the activities or conduct of individual Member States or of individual enterprises in connection with a specific business transaction" (UN General Assembly 2015, §98). Hence, the implementation and enforcement mechanisms of the Guidelines for Consumer Protection are still in the hands of the member states and are prone to capture.

19.3 Case VIII: UN Guiding Principles on Business and Human Rights

The UN Guiding Principles on Business and Human Rights regulate the roles businesses and governments take in facilitating the affirmation that companies respect human rights[73] in their operations and throughout their business relationships. A team led by Professor John Ruggie established the principles. The UN Secretary General appointed him Special Representative for Business and Human Rights in 2005. He first proposed a UN 'Protect, Respect and Remedy' Framework to the UN Human Rights Council in 2008. This framework is based on three pillars:

> *1. the state duty to protect against human rights abuses by third parties, including business entreprises, through appropriate policies, regulation, and adjudication;*
>
> *2. an independent corporate responsibility to respect human rights, which means that business entreprises should act with due diligence to avoid infringing on the rights of others and address adverse impacts with which they are involved;*
>
> *3. the need for greater access by victims to effective remedy, both judicial and nonjudicial. (Ruggie 2013: xx-xxi)*

After his proposition, the Human Rights Council extended Ruggie's mandate for another three years. He was instructed to operationalize and endorse the framework. In 2011, Ruggie and his team presented a set of principles within the report „Guiding Principles on Business and Human Rights: Implementing the United Nations 'Protect, Respect and Remedy' Framework". The framework includes foundational and operational principles for states' duty to protect human rights and corporations' responsibility to respect human rights. Furthermore, it structures how states and corporations alike should ensure that those affected have 'access

[73] The human rights addressed by the principles are the International Bill of Human Rights, including the Universal Declaration of Human Rights with its „instruments through which it has been codified" (i.e. International Covenant on Civil and Political Rights, International Covenant on Economic, Social, and Cultural Rights), and the eight core conventions of the ILO (OHCHR 2011, 14; see also UN General Assembly 1966b; UN General Assembly 1966a; UN General Assembly 1948; ILO 2003)

to remedy' (OHCHR 2011, 27–35). In the following, I briefly address some of the responsibilities corporations have in regard to respecting human rights. Principle 11 entails the core demand that corporations „should respect human rights […] wherever they operate" and applies regardless of the „states' abilities or willingness to fulfill their own human rights obligations" (OHCHR 2011, 13). Principle 13 (b) states further that corporations have a responsibility to „prevent or mitigate adverse human rights impacts that are directly linked to their operations". Although it is acknowledged that SMEs may struggle to meet all the requirements of the Guiding Principles on Business and Human Rights due to less capacities, and more informal procedures and management than bigger corporations, also SMEs can cause adverse human rights impacts and are equally responsible for their conduct (Principle 14) (OHCHR 2011, 14–15).

Establishing the Guiding Principles on Business and Human Rights included intense consultations with a diverse set of stakeholders, such as experts, affected individuals, companies, NGOs, and workers' organizations (Ruggie 2013, xx). At the presentation of the report in May 2011 in Geneva, Ruggie talked about methods they used to inform the Guiding Principles with opinions and voices from diverse stakeholders.

> *With help from all stakeholder groups, the mandate convened 47 international consultations, on every continent. Members of my team and I made more than 20 site visits to business operations and communities, learning from the diverse experiences of affected individuals and groups, local leaders, civil society and company representatives. […] Finally, the draft Guiding Principles I released last November were thoroughly vetted by governments in an informal council consultation and in written submissions, while an online consultation attracted comments and suggestions from individuals and institutions in more than 120 countries. (Ruggie 2011: 5)*

The support for the UN Guiding Principles on Business and Human Rights is widespread and the public and private sector endorse the principles. Although the support is extensive, there is ongoing criticism that the principles leave loopholes and are too flexible in their interpretation. In the following, I touch upon the two main critiques the Guiding Principles on Business and Human Rights face. The *first* point concerns a discussion, which revolved around the question of whether corporations should 'only' have the responsibility to implement the principles or have a duty to do so (Bilchitz 2009, 8). The *second* point concerns the critique that the UN Guiding Principles on Business and Human Rights would require an oversight mechanism to check whether member states and corporations comply with the guiding principles (Bader 2012, 8).

Corporations' Responsibility to abide by the Guiding Principles

In contrast to the understanding of responsibility I brought forward in Chapter 14, Ruggie clearly differs between responsibility and duty. Ruggie refers to state obligations as duties and to corporation obligations as responsibilities. He understands states' duties as hard law and corporations' responsibilities as the consequence of the public's expectations.

> *In addition to compliance with national laws, the baseline responsibility of companies is to respect human rights. Failure to meet this responsibility can subject companies to the courts of public opinion - comprising employees, communities, consumers, civil society, as well as investors - and occasionally to charges in actual courts. Whereas governments define the scope of legal compliance, the broader scope of the responsibility to respect is defined by social expectations - as part of what is sometimes called a company's social license to operate. (Ruggie 2008, §54)*

This goes along with the understanding Lane (2005, 233) portrayed three years earlier: „Accountability in its fullest sense can only be demanded of corporations by and through the law", if this is not possible the „call for 'corporate accountability' sometimes appeals instead to a vaguer notion of informal social – rather than legal – accountability"[74]. In this scenario, the public takes on the role of the state and substitutionally demands the corporations to abide by human rights. Conditioning the responsibility of

[74] Accountability is here to be understood as responsibility.

corporations to abide by human rights on social expectations though raises yet another issue that is taken up by Bilchitz (2009, 45). He gives the example of a country that has been ruled by a dictator for several years. In this case, society's expectations regarding companies which enhance their abidance by human rights might be very low. Furthermore, societies will not have the necessary information to even detect such human rights violations. Hence, basing the argument that companies will take their responsibility to respect human rights on social expectations might reproduce the status quo and hence human rights violations. Bilchitz (2009, 8) claims that respect is too low a standard, and although the UN Guiding Principles on Business and Human Rights have managed to find a „global consensus, Ruggie's framework goes too far in sacrificing principle for the purposes of achieving agreement".

Lacking of an Oversight Mechanism

The lack of an oversight mechanism for the guiding principles is the second point that received a lot of criticism (Bader 2012, 8). Such a mechanism could render the soft law principles enforceable and therefore considerably harden them. The debate about the criticized soft law character of the guiding principles was fueled in late 2013 when several states and two regional country organizations[75], led by Ecuador, suggested introducing a binding legal instrument for corporations (Ecuador Resolution 2013; Treaty Alliance 2015). Also over 140 NGOs supported this request and issued a joint statement demanding the UN Human Rights Council takes steps to draft such an instrument. From 2013 to December 2015 more than 400 organizations signed the joint statement (Treaty Alliance 2015). Due to these developments, the UN Guiding Principles on Business and Human Rights embodies the most promising global human rights framework to be rendered binding for corporations. Resolution 26/9 adopted by the UN

[75] The following countries called on the UN Human Rights Council: Pakistan, Sri Lanka, Kyrgyzstan, Cuba, Nicaragua, Bolivia, Venezuela, Peru, Ecuador, the Arab League, and the African Group (Treaty Alliance 2015).

General Assembly shows the determination of the UN to establish such a mechanism[76]:

> *The Human Rights Council, […]*
>
> *1. Decides to establish an open-ended intergovernmental working group on transnational corporations and other business enterprises with respect to human rights; whose mandate shall be to elaborate an international legally binding instrument to regulate, in international human rights law, the activities of transnational corporations and other business enterprises;*
>
> *2. Also decides that the first two sessions of the open-ended intergovernmental working group shall be dedicated to conducting constructive deliberations on the content, scope, nature and form of the future international instrument, in this regard[.] (UN General Assembly 2014, 2)*

The first draft report of the open-ended intergovernmental working group on transnational corporations and other enterprises with respect to human rights that was issued in July 2015 resonates with the criticism brought forward above. The report summarizes the contributions of the panelists, state delegations and NGOs present for the first session of the working group. A majority of the delegations emphasized that the UN Guiding Principles are too intangible regarding the language used for the responsibilities of corporations. They add for consideration that if the treaty should be binding, it has to go beyond corporate responsibility. The treaty should therefore include a „direct obligation to prevent, mitigate and redress the human rights abuses occasioned by their operations" (Garcés 2015, §72). With this strategy „pick and choose approach[es]" in regard to respecting human rights selectively by corporations could also be prevented (Garcés 2015, §68). The issue of a lacking enforcement mechanism is

[76] Countries that voted in favor: Algeria, Benin, Burkina Faso, China, Congo, Cote d'Ivoire, Cuba, Ethiopia, India, Indonesia, Kazakhstan, Kenya, Morocco, Namibia, Pakistan, Philippines, Russia, South Africa, Venezuela, and Vietnam; countries that voted against: Austria, Czech Republic, Estonia, France, Germany, Ireland, Italy, Japan, Montenegro, South Korea, Romania, Macedonia, the UK, and the United States of America; countries that abstained: Argentina, Botswana, Brazil, Chile, Costa Rica, Gabon, Kuwait, Maldives, Mexico, Peru, Saudi Arabia, Sierra Leone, and the United Arab Emirates (UN General Assembly 2014, 3).

especially connected to the problem of differing domestic legal systems that allow for inequalities. A few delegates stated that domestic possibilities to file a suit in regard to human rights abuses committed by corporations were „patchy, unpredictable and ineffective" (Garcés 2015, §88). Several NGOs advocated an overarching enforcement mechanism, such as a „committee for compliance oversight" or a „world court or tribunal", to complement domestic and regional ones (Garcés 2015, §89). Finally, most non-governmental organizations noted that a binding treaty could fill in gaps of the guiding principles (Garcés 2015, §73). This however, would presuppose the second pillar of the UN Guiding Principles, namely that there is an independent corporate responsibility to respect human rights, to be well defined. One panelist[77] argued „responsibility under international human rights law entails legal accountability and legal duty. However, 'responsibility' as used under the second pillar of the UN Guiding Principles does not reflect this understanding" (Garcés 2015, §69). If the object of this treaty is to represent a binding instrument, there has to be a clear definition of what responsibility means or at least there has to be a common understanding of the meaning of responsibility among the parties (Garcés 2015, §53, §55, §69). Connected to this, there is another definitional issue concerning the type of human rights enforceable within this binding treaty. This is of special importance because it is affecting whether the UN Guiding Principles could be applicable to the context of the framework of responsible microfinance. The scope of human rights that will be included in the binding treaty is key to whether the framework of responsible microfinance can benefit from it. As of the current state of affairs most panelist, delegations and NGOs are favoring a non-limitation approach, meaning that all human rights are subject to the treaty and not only gross human rights violations[78] (Garcés 2015, §56, §57).

[77] For the list of all panelist, please see Garcés (2015, Annex II)

[78] Limiting the scope could again set incentives to selectively abide by some human rights (Garcés 2015, §56).

19.4 Case IX: Smart Campaign’s Client Protection Principles and Certification Program

Smart Campaign is a transnational soft law standard-setting body in the specific field of microfinance client protection. The aim of Smart Campaign is to provide a guideline – the Client Protection Principles – for MFIs to manage risks of having an adverse impact on microfinance clients with the underlining ethical maxim of ‘doing no harm’. The task of the principles entails specifying what to ‘do no harm’ includes in day-to-day microfinance practice (The Smart Campaign 2015c). In 2009, Smart Campaign as an institution to foster client protection principles was launched by CGAP and CFI. Smart Campaign, here defined as a transnational institution, is supported and informed by the steering committee, which consists of 21 individuals from 13 countries that represent central banks, MFIs, development agencies, microfinance networks, donors and investors[79]. In addition, there is one campaign director and operational and communication manager. Unfortunately, there is no information on how and by whom the steering committee and the leadership of the campaign were elected or chosen.

Smart Campaign’s Client Protection Principles

In July 2011, Smart Campaign introduced seven ‘Client Protection Principles’. These principles emerged over a period of approximately two years and they were inspired and informed by preceding research and practices. Namely already in 2005, scholars argued in favor of the protection of microfinance borrowers and discussed most of the principles included in the current Client Protection Principles (Porteous and Helms 2005). One year before, ACCION, a network of leading MFIs, which was one of the main initiators of the Smart Campaign, established and adopted the so-called ‘Pro-Consumer Pledge’, which was formulated in a quite similar way as the Client Protection Principles are today (ACCION 2004). Especially,

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[79] A complete list of the steering committee and leadership of the campaign you find here: http://www.smartcampaign.org/about/campaign-steering-committee [last accessed 10.04.2016].

three developments led to the first draft of the Client Protection Principles. The *first* development was microfinance experts coming together to sign the Pocantico Declaration expressing their commitment to a form of microfinance which emphasizes client benefit and well-being and accounts for both social and financial performance. One of the action steps defined in this document was:

> *Developing and promoting common principles and standards at various levels among existing and new actors including funders and financial service providers, which should address consumer protection, social performance, pricing transparency, and promotion of financial literacy through client education. (Microfinance Leaders 2008, 2)*

The Pocantico Declaration also called for an international task force to work towards enhanced client protection. The *second* development was CGAP taking the lead in merging existing codes of conduct in the field of microfinance client protection (e.g. Pocantico Declaration, other microfinance networks' codes of conduct) into six client protection principles. The *third* development was the action research project called 'Beyond Codes' of the Center for Financial Inclusion. Acknowledging the call for an international task force to work towards enhanced client protection of the Pocantico Declaration, the center started building a coalition of MFIs, microfinance networks, NGOs, and professionals from the public and private sector, which is today known as the Smart Campaign. The six client protection principles put together by CGAP were the starting point of Smart Campaign's Client Protection Principles and were first sent out to experts and practitioners to comment on in 2009. In a second round of consultations the draft was also directed to the wider public asking for comments, feedback and inputs in regard to the principles until July 2011. After these deliberations the principles underwent critical changes[80]. The

[80] Please find all principles with adaptations made in July 2011 and explanations here: http://www.smartcampaign.org/storage/documents/20110916_SC_Principles_Guidance_Draft_Final.pdf [last accessed 26.05.2015]. Changes entailed among other points, that the CPPs are applicable to multiple products (not only to credit), alterations in regard to wording and presentation order, including a non-discrimination clause (principle 5: fair and respectful treatment of clients) (see The Smart Campaign 2011: 1).

revised principles tackle all the critical issues discussed in part two of this research endeavor (Schicks 2010; Schicks 2011a; Schicks 2011b; Schicks 2012; Schicks and Rosenberg 2011; Karnani 2011, 50; Ardic, Ibrahim, and Mylenko 2011, 8–10):

1. Appropriate Product Design and Delivery
   The design of products and the delivery of products should take into consideration the characteristics of clients and their potential vulnerability (The Smart Campaign 2011b). It is important to clients that they may purchase products that are easily accessible and, for example, feature flexible repayment schedules (The Smart Campaign 2012, 2), because clients' investments and repayments are often dependent on seasonality (e.g. harvest period, raining season) (Schicks 2010, 10).

2. Prevention of Over-Indebtedness
   MFIs take measures in order to assess whether clients will be able to repay without becoming over-indebted. MFIs will also „implement and monitor internal systems that support prevention of over-indebtedness and will foster efforts to improve market level credit risk management (such as credit information sharing)" (The Smart Campaign 2011b).

3. Transparency

   Information provided by MFIs should be „clear, sufficient, [...] timely" and comprehensible for clients so they may make informed decisions (The Smart Campaign 2011b). Regarding transparency, especially the disclosure of pricing information but also information on a product's terms and conditions is important.

4. Responsible Pricing

   The responsible pricing standard represents the double bottom line character of microfinance. The price, terms and conditions of a product will be set so it is affordable to clients and at the same time allowing MFIs be financially sustainable (The Smart Campaign 2011b).

5. Fair and Respectful Treatment of Clients

   Treating their clients fairly and in a respectful manner includes that MFIs should not apply any kind of discrimination and that there is no leeway for corruption. Personnel is furthermore prohibited from using force against or in any way abuse clients, this applies especially during loan sales and debt collection processes (The Smart Campaign 2011b).

6. Privacy of Client Data

   MFIs will respect the privacy of individual client data and will act in compliance with laws and regulations of state jurisdictions. Unless the client gives his or her informed consent, data will „only be used for the purposes specified at the time the information is collected or as permitted by law" (The Smart Campaign 2011b).

7. Mechanisms for Complaint Resolution.

   MFIs put in place „timely and responsive" mechanisms for complaint resolution for the clients and „will use these mechanisms both to resolve individual problems and to improve their products and services" (The Smart Campaign 2011b).

Although financial education is important in regard to the protection of microfinance clients, there is no principle included addressing this issue. I will shortly respond to that notion. Financial IOs promoting financial consumer protection (G20/OECD Task Force on Financial Consumer Protection 2011; The OECD International Network on Financial Education (INFE) 2012; Hubbard-Solli 2013; The World Bank 2012). As already mentioned, the provision of financial education by MFIs is better understood as an extra, which is commonly known as „microfinance plus"[81], than as a necessary element of microfinance. The core business of microfinance is still the supply of financial services to low-income individuals[82]. Furthermore, MFIs argue that financial education and education in general do not exclusively, or if at all, some might argue, fall under the responsibility of the MFI (i.e. diffusion of responsibility). For many smaller MFIs additional requirements in regard to financial education would be too demanding due to the possible lack of trained staff and moreover be too expensive from a financial point of view.

In order to adapt to the change within the microfinance industry, Smart Campaign revises their Client Protection Standards every three years. As we see later on, the Smart Campaign's Client Protection Principles aspire to gather as much feedback, input, and comments as possible on the disputable principles from stakeholders. Smart Campaign strives to comply with the ISEAL Code of Good Practice on Standard Setting. The ISEAL Code aims to make standards more credible. To establish credible standards the ISEAL Code presets how the standards should be determined. It starts from a proceduralist thesis that credibility is reached when standards are created by means of deliberating the standards with all stakeholders and in a transparent way (ISEAL 2014). Until the 30th of November 2015, the Client

[81] Microfinance plus services include non-financial services (e.g. financial, health, energy or environmental education and programs).

[82] For an overview of the discussion of whether MFIs should also provide non-financial services please see Orbuch (2011) and Lensink, Mersland and Nhung (2011).

Protection Principles 3.0 comment period was in progress. Although scheduled to be online in January 2016, the Principles have not yet been published. The main changes will presumably represent the simplification of the principles to diminish redundancy and the allowance of new technical areas, especially regarding savings, insurance and digital finance (The Smart Campaign 2015a).

The seven client protection principles are widely endorsed by funders, investors, supporting organizations, and individuals. Around 1600 MFIs recognize the principles[83] (The Smart Campaign 2015d). Compared to data sharing organizations, such as Mix Market, where around 2000 MFIs are registered[84], one can estimate the wide support Smart Campaign's principles have among MFIs.

Smart Campaign's Certification Program

Nevertheless, the initial and designated strategy of the principles was that MFIs would self-report on their degree of abidance. This strategy was quickly deemed insufficient. Therefore, Smart Campaign advocated a third-party certification: the Client Protection Certification Program. The program was launched in 2010 and was developed, evaluated and tested for three years. Until 2013 it included the core products of microfinance (The Smart Campaign 2011a; The Smart Campaign 2013; The Smart Campaign 2014). For the certification program, Smart Campaign has operationalized every principle. So, they attributed indicators to all seven client protection principles to render them measurable (The Smart Campaign 2013). Currently, there are 46 MFIs certified providing over 21 million microfinance clients with financial services (The Smart Campaign 2015b).

Coordinated by Smart Campaign, the certification procedure was a result of the cooperation among and consultation with microfinance

[83] The 4531 endorsers, are composed of 1600 MFIs, 186 networks and associations, 184 investors and donors, 354 supporting organizations, 2207 individuals (The Smart Campaign 2015d).

[84] About 2000 MFIs report their data to the Mix Market, a public data hub for MFIs to publish their institutional data (Mix Market 2015b). There is no difficult procedure preceding the registration and the MFI can also submit a very limited amount of information (Mix Market 2015a).

stakeholders, which included also consultations with clients. A certification task force of 43 experts representing international network organizations (e.g. Women's World Banking), special interest groups (e.g. SEEP, Pakistan Microfinance Network), rating agencies (e.g. Microrate, Moodys, M-CRIL), funders and investors (e.g. Hivos, Kiva, INCOFIN), two independent consultants, and financial institutions (e.g. Ujjivan, FMMB), established in 2010 led the three-year process to finalize the certification program. Again there is no information available how this task force was elected and put together. Two important outputs of the task force discussions were that becoming and staying certified must require a substantial commitment from the side of MFIs (1) and adherence should not only be verified via the numbers and information provided to the rating officers by the MFI, but also clients should be interviewed on their opinion about how their MFI implements client protection (2). Once an institution is certified, the certification has to be renewed on a two-year base. Another output is that the certification program features an appeals and complaints system (3). MFIs may appeal against certification decisions which concern themselves. Smart Campaign processes these appeals. If a certification body violates Smart Campaign's procedures or protocols, Smart Campaign investigates these violations and applies appropriate measures. What these measures will include has yet to be concretized. In contrast to appeals, there are three sorts of complaints that can be filed: complaints about certified financial institutions, complaints against accredited certifiers, and complaints about Smart Campaign accreditation system or certification program. Complaints about a certified MFI have to be always first directed to the MFI itself over a grievance or redress system. If this strategy proves unsuccessful, the complainant should contact a relevant complaint system, for example a nationwide body (e.g. ombudsman for financial services). Only as a last step, is it possible to call on Smart Campaign to investigate the case. If it is a complaint directed at an accredited certifier, the escalation matrix is similar. The certification body should be confronted with the complaint. If the issue cannot be resolved, the complainant can call upon Smart Campaign to help resolve the problem. In the case of a complaint against Smart Campaign's Client Protection Principles or the Certification Program the first, and until now, last instance to call upon is Smart Campaign itself (The Smart Campaign 2014)[85]. It seems at least there is no clear information on the issue that the appeals and complaints system has only recently been established and is still evolving. For example, the complaints against accredited certifiers and against Smart Campaign's principles and certification program have only two instances (i.e. certification body followed by Smart Campaign) and only one instance respectively (i.e. Smart Campaign). In both cases a higher instance is indicated, but not yet defined (i.e. NA). The certification program is revised every two years. It is possible that the complaint procedures will be completed by the next revision.

The certification program proposal which the task force put together, was sent out for a round of consultation from October 2011 to February 2012. It included the client protection principles against which the performance of the MFI should be assessed and the proposed methodology to do so. In 2012 Smart Campaign ran a pilot program, testing and adapting the program in close collaboration with specialized microfinance rating agencies before launching the full program in 2013 (The Smart Campaign 2014).

Until today, only 46 out of 1600 MFIs that endorse the principles are certified and thus evaluated on a regular bases in regard to their compliance with the principles (The Smart Campaign 2015d). Hence, when taking the majority of 1550 MFIs into account, the principles are only enforced by a minority of MFIs over the certification program. One reason for the seemingly slow uptake of the Certification Program may well be connected to the high requirements demanded from the MFIs. As already discussed above: If requirements are too high, MFIs might not be able, even if they wanted to, to become certified due to lack of knowledge,

[85] It is questionable whether Smart Campaign is the adequate institution to manage complaints directed towards its own conduct or even towards the conduct of certifiers that work for Smart Campaign. If there is a need for an oversight body controlling standard-setting bodies like Smart Campaign this will be discussed as a possible practical implication of this research project in Chapter 21.3.

human capital, financial resources, or infrastructure. For example, the cost for a certification mission of a rating agency can go up to 18,000 USD. This amount includes preparation, on-site visit and post visit analysis, and the optional progress phase. Possible certifiers are M-Cril, MicroFinanza Rating, MicroRate and Planet Rating, which are private companies. If combined with another rating, costs are about 12,000 USD (The Smart Campaign 2014).

19.5 Case X: The Social Performance Task Force's Universal Standards for Social Performance Management

Established in 2005, the Social Performance Task Force (SPTF) calls itself a membership organization, registered as a NGO in the United States, with over 2700 individual members from 128 countries and 194 organizational members that aims to endorse the soft law standards called Universal Standards for Social Performance Management within the microfinance industry (Social Performance Task Force 2016a). The members with 'organizational membership'[86] are eligible to elect and be elected members of the SPTF's board of directors. The board of directors is composed of 13 elected members[87]:

- two donors,
- two investors,
- two MFIs (one NGO and one NBFI or bank),
- three MFI associations (one global, one regional, and one national),
- two support organizations,
- two audit, rating and information services,
- up to three appointed members to ensure regional diversity,

[86] To be granted organizational membership requires meeting higher standards than an individual membership. Applicants must write an application letter, signed by a senior manager or a member of the board of directors, and must proof their commitment to „promoting and implementing" the universal standards (Social Performance Task Force 2016b).

[87] For a complete list of the members of the board of directors, see http://sptf.info/about-us/board-of-directors [last accessed 16.02.2016].

- and Laura Foose, the current SPTF Director, who serves as an ex-officio member of the board

At the SPTF annual meeting in 2010 the member organizations decided to develop the Universal Standards for Social Performance Management ('universal standards'), to complement the existing social performance initiatives, such as Smart Campaign's Client Protection Principles ('client protection certification standards'). The main target was to go further than the Smart Campaign's Client Protection Principles, which were developed to protect clients from harmful practices. As the SPTF states, the universal standards aim to not only live up to the maxim of „doing no harm" but rather to „doing good", which means to not only protect clients but create value for them (Social Performance Task Force 2014b, 3). The encompassing and demanding universal standards developed and were published in 2014 (Social Performance Task Force 2014a, 10). Forming the universal standards included extensive participatory possibilities and included two phases, one 18 months and one 12 months long, of development that were managed by the SPTF secretariat[88]. *Phase one* included the SPTF secretariat to outline a rough first draft on the bases of existing social performance initiatives, research, and data. The initial draft was informed by input from task force members and experts outside of the task force. The SPTF gained its feedbacks over several participatory channels: „working groups that met multiple times, surveys, webinars, and five public comment periods and direct discussions with microfinance institutions conducted by networks" (Social Performance Task Force 2014a, 10). In the final stage of phase one, the SPTF's board of directors completed their last review on the universal standards and ratified them in June 2012. *Phase two* represented the beta testing stage. Eight key microfinance networks and ten national microfinance associations started to globally evaluate the implementation of the universal standards in their partnering MFIs. Furthermore, 40 national microfinance associations and their MFI members took part in an awareness-raising campaign and gave

[88] For a complete list of the members of the secretariat, please see http://sptf.info/about-us/secretariat [last accessed 16.02.2016].

detailed feedback on the universal standards[89]. In a last step and according to the input, SPTF adopted the changes, submitted the final draft for the last review and ratification to the SPTF's board of directors (Social Performance Task Force 2014a, 10).

In 2014, the Universal Standards for Social Performance Management were ratified and included six dimensions[90]. The Universal Standards for Social Performance Management also incorporate the Smart Campaign's Client Protection Standards as they were introduced in Chapter 19.4[91]. In the following, I summarize the main points of the comprehensive six dimensions of the universal standards.

1. Define and monitor your social goals
   There should be indicators measuring how clients benefit from receiving financial services. Outputs (i.e. actions taken by the MFI to enhance clients' social and economic well-being) as well as outcomes (i.e. changes in the social and economic well-being caused by the financial services provided) should be measured. The MFI collects and reports detailed data for every social goal it commits to (Social Performance Task Force 2014a, 15–16).

2. Ensure board, management and employee commitment to social goals
   Board members know about the MFI's social mission and their responsibilities in this regard. The board monitors the social performance data and uses insights for strategic direction. This includes balancing social and financial performance, and preventing

[89] See for example the detailed report on the insights from beta testing the universal standards summarized by the Microfinance CEO Working Group in May 2013 (Microfinance CEO Working Group 2013).

[90] See http://sptf.info/images/usspm%20englishmanual%202014-05-09.pdf [last accessed 16.02.2016] for a detailed description of the universal standards.

[91] For the complete list of client protection principles and their according standards and indicators, please see https://centerforfinancialinclusionblog.files.wordpress.com/2013/08/certification-standards_english-1-22-mb.pdf [last accessed 16.01.2016].

mission drift in case of changing the ownership structure of the MFI (Social Performance Task Force 2014a, 18).

Senior management is mandated to implement the social performance goals into effect with a special focus on raising awareness about fair and responsible treatment of clients. This focus is mirrored in client protection certification standard 5.1 and its corresponding indicators. It also assesses whether the reported social performance data corresponds to the stated social targets. Senior management is held responsible for improvements regarding attaining the social goals (Social Performance Task Force 2014a, 19).

Employees commit to the MFI's social targets. They are trained and assessed concerning both, their social and financial performance responsibilities. The MFI realizes policies to encourage ethics and the prevention of fraud as stated in client protection certification standard 5.4. MFIs further incentivize loans that are tailored to the client's needs in line with Smart Campaign's Client Protection Certification Standard 2.2 (Social Performance Task Force 2014a, 20).

3. Design products, services, delivery models and channels that meet clients' needs and preferences

   The MFI aims to collect client's opinions about its services and translates the feedbacks into product design and delivery adjustments according to client protection certification standard 1.2. MFIs further evaluate client satisfaction and seek to understand why clients are leaving the institution (Social Performance Task Force 2014a, 22).

   MFIs aim for appropriateness of product design, meaning to develop products that meet clients' needs and do no harm (client protection certification standard 1.1). While providing clients with services, the MFI focuses on creating client benefits and refrains from using aggressive sales practices in line with the client protection certification standard 1.3 (Social Performance Task Force 2014a, 23).

4. Treat clients responsibly

   The MFI aims to prevent over-indebtedness in conducting a thorough assessment of the financial situation of a client before disbursing a loan (see client protection certification standard 2.1). To evaluate repayment capacity the MFI may use credit bureau and competitor data (client protection certification standard 2.3). The risk posed by over-indebtedness is appreciated by the leading management and the internal audit team monitors appropriate measures that have been taken to mitigate over-indebtedness (client protection certification standard 2.5). The MFI refrains from „dangerous commercial practices" as they are described in client protection certification standard 2.6 (The Smart Campaign 2013; Social Performance Task Force 2014a, 25).

   In line with the client protection certification standards 3.1 to 3.5 the MFI is transparent in its disclosure of costs and communication. It provides the client with several disclosure mechanisms, enough time to consider the product offer, all her documents she has signed, and access to her account information (Social Performance Task Force 2014a, 26).

   The MFI treats its clients fairly and respectfully (client protection certification standards 5.2-5.3 and 5.5-5.7). Collection practices are defined and appropriate. The selection and treatment of clients does not show any characteristics of discrimination against certain clients. The clients are informed about the rights they have to, for example, understand and make use of complaint mechanisms (Social Performance Task Force 2014a, 27).

   The MFI actively manages client data and its privacy. Clients are informed about how and when their data is used and liable to get their consent (Social Performance Task Force 2014a, 28).

   In line with client protection certification standards 7.1 to 7.4, the MFI has mechanisms for complaints and their resolution in place. Clients are aware of the mechanisms and understand them (Social Performance Task Force 2014a, 29).

5. Treat employees responsibly

   The MFI sets in place a human resources policy which is available to all employees and complies with state law. Employees have to be able to file a grievance through a confidential system. Further, the MFI refrains from forced or child labor (Social Performance Task Force 2014a, 31).

   All employees receive the terms of their employment and receive training for their corresponding job function (Social Performance Task Force 2014a, 32).

   The MFI oversees the satisfaction of their employees and their turnover and takes measures to mitigate discontent and high turnover (Social Performance Task Force 2014a, 33).

6. Balance financial and social performance

   The MFI „sets and monitors growth rates that promote both financial sustainability and client well-being" (Social Performance Task Force 2014a, 35).

   All actors involved in the financing and leading the MFI (e.g. equity investors, board of directors, management) are committed to the MFI's double bottom line and aim to put into practice a financial structure that accounts for the stated social as well as financial targets (Social Performance Task Force 2014a, 36).

   In line with the client protection certification standard 4.1 to 4.3 pursuing profit does not mean neglecting client well-being or to undermining the long-term sustainability of the MFI. Clients receive quality products for a price. The MFI considers that prices are market-based and non-discriminatory. There is no allowance for excessive fees. The board further monitors whether pricing levels are in line with expected returns (Social Performance Task Force 2014a, 37).

   The remuneration of the management of the MFI is appropriate to the MFI's social targets. If the salary is incentive- or performance-based the manager's achievements regarding the MFI's financial and social targets has to be considered (Social Performance Task Force 2014a, 38).

In order to adjust to the changes within the microfinance industry, the Social Performance Task Force plans to revise the universal standards once every three years. The first revision planned to start in June 2016. In order to prevent for inefficiencies, the task force strives to schedule revisions after the Smart Campaign's Client Protection Principles has published their revised principles. The task force, Smart Campaign, and CERISE, which developed a social audit tool (SPI4)[92], have in fact synchronized their schedules of revision. This helps harmonizing the existing standards for client protection and social performance in microfinance and streamlining their reviewing processes. For the update of the universal standards in June 2016, the task force has created a Universal Standards Technical Review Committee. It involves various stakeholders including ten permanent organizational members, three members of the SPTF board of directors, two to four appointed members that represent important initiatives in financial services supply, and up to five members elected by the organizational members of the task force representing practitioners from different world regions[93]. These last five members are specifically elected for the review process and will be elected by the organizational members of the SPTF. Besides the review committee also the public is given several channels to supply their input in English, French, or Spanish. Possibilities include sending emails to the SPTF[94], participating in the online surveys, which will be open for 60 days in spring of 2016, and taking part in interviews and focus groups conducted in the field. The review committee is responsible for

[92] For more detailed information, see http://www.cerise-spi4.org/ [last accessed 16.02.2016].

[93] To see the full list of the members of the technical review committee and for the foreseen time schedule of the revision process within the technical review committee and already received inputs, see http://sptf.info/universal-standards-for-spm/http-www-sptf-info-state-of-practice [last accessed 16.02.2016].

[94] Emails can also be sent to Smart Campaign and CERISE, which forward the inputs to the SPTF.

examining the received comments and translating the input into a revised set of the universal standards (Social Performance Task Force 2016d).

The universal standards, as mentioned above, are not mandatory and do not include any certification. However, there are social rating agencies that use tools, which enable them to assess the extent of MFIs' compliance with the universal standards (Social Performance Task Force 2014a, 13). There is also the possibility to use CERISE's tool for MFIs to self-assess their levels of compliance with the universal standards for social performance called SPI4 (CERISE 2016). Additionally, SPTF provides MFIs interested in self-regulation with case studies showing in what way other MFIs have already put the universal standards into effect (Wardle 2014, 10–24).

19.6 Analysis of the Cases Against the Backdrop of the Common Interest Regulation Theory

I have discussed two cases of soft law standards on the international level and two cases on the transnational level. In the following, I will try to ascribe each case to one category of the analytical framework of Mattli and Woods (2009, 16). Therefore, it has to be determined, which scenario – capture regulation with compromises (A), common interest regulation (B), pure capture regulation (C), or de facto capture regulation (D) – has been fulfilled for each case. Thereby, the whole regulatory process from agenda setting to enforcement shall be considered for institutional supply and the extent of societal demand for regulatory change.

For each case, I *first* state whether the extent of institutional supply is rather characterized by „open forums, proper due process, multiple access points, and oversight mechanisms" or whether it is rather „exclusive, closed, and secretive" (Mattli and Woods 2009, 17). The results are summarized in Tables 1 to 4. *Second*, I discuss the extent of societal demand for each of the four cases. I evaluate the cases with the demand-side conditions (i.e. information, interests, ideas) that have to be fulfilled.

Finally, I locate the position of the cases discussed within the analytical framework of common interest regulation and present them in Figure 7.

19.7 Institutional Supply of the Four Cases

In regard to Case VII – *UN Guidelines for Consumer Protection* – institutional supply seems to be somewhere between the two categories. Although many stakeholders impact agenda setting and the negotiation of standards, the possibility of participating weakens regarding implementation, monitoring and enforcement. In this regulation formation phase it is the prerogative of the UN member states to influence how the guidelines are finally implemented and enforced.

Regulatory Process Phase	**Main Actors**	**Participatory Channels**	**Institutional Supply**
Agenda Setting	• states • experts • multilateral orgs. • national and int. consumer protection organizations	• UN asks for contributions • Questionnaires sent out by UN • expert groups	*extensive*
Negotiation of Standards	• states • experts • multilateral orgs. • national and int. consumer protection organizations	• UN provides framework to build working groups to establish draft guidelines	*intermediate* (access to working groups is limited)
Implementation, Monitoring, and Enforcement	• states	• UN General Assembly adopts resolution about the Guidelines for Consumer Protection • intergovernmental group of experts monitors as described in §97 of the guidelines • states should establish or encourage procedures to enforce guidelines	*limited* to group of experts

Table 1: Extent of Institutional Supply: UN Guidelines for Consumer Protection

Regarding Case VIII – *UN Guiding Principles on Business and Human Rights* – institutional supply is rather extensive over the whole regulatory process. Even the critical phases of the regulatory process (i.e. implementation, monitoring and enforcement) allow for the participation of several stakeholders. Nevertheless, the inter-governmental working group is exclusive, but allows NGOs, experts, and state delegations to contribute at the regular group meetings.

Regulatory Process Phase	**Main Actors**	**Participatory Channels**	**Institutional Supply**
Agenda Setting	• states • experts • academics • multilateral orgs. • NGOs • individuals	• John Ruggie and team conduct extensive consultations with group and individual stakeholders to detect crucial issues • Online platform for individuals to comment	*extensive*
Negotiation of Standards	• states • experts • multilateral orgs. • NGOs • individuals	• John Ruggie and team conduct extensive consultations with group but also individual stakeholders to inform guidelines • Online platform for individuals to comment	*extensive*
Implementation, Monitoring, and Enforcement	• state delegations • experts • NGOs	• Open-ended intergov. working group mandated to establish a binding instrument • Meetings of the group open to NGOs, experts and state delegates	*extensive*, with constraint of exclusiveness of intergov. working group

Table 2: Extent of Institutional Supply: UN Guiding Principles on Business and Human Rights

For Case IX – *Smart Campaign's Client Protection Principles and its Certification Program* – institutional supply is rather extensive over the whole regulatory process. The agenda setting process was influenced by several pro-change forces in the domain of client protection in microfinance; however, finally it was CGAP that distilled the main points of several existing codes of conduct into the six client protection principles we know as the first draft of the Smart Campaign's Client Protection Principles. The implementation, monitoring and enforcement phase constituted the formation of the certification program. Also in this phase various stakeholders were allowed to participate. Thereby, it has to be noted that the first round of consultation was exclusively open to the task force group of experts[95], only the second round again allowed for wide participation of a diverse set of stakeholders again.

[95] As mentioned above though, there is no information how the task force group of experts was elected.

Regulatory Process Phase	Main Actors	Participatory Channels	Institutional Supply
Agenda Setting	• microfinance experts • CGAP • Center for Financial Inclusion	• There was a wide discussion within a loose coalition of several pro-client protection forces, and finally CGAP, which is already a coalition of diverse public and private actors in itself proposed the first draft of the principles	*extensive*, the first draft however was put together by CGAP
Negotiation of Standards	• development agencies • microfinance experts • academics • NGOs • MFIs • individuals	• two rounds of consultations 1. with experts and academics, development agencies, clients 2. open to all	*extensive*
Implementation, Monitoring, and Enforcement	• task force group of experts • development agencies • microfinance experts • academics • NGOs • MFIs • individuals	• two rounds of consultations 1. with certification task force group of experts 2. open to all	*extensive*, with the constraint of not knowing how the task force was elected

Table 3: Extent of Institutional Supply: Smart Campaign's Client Protection Principles and Certification Program

Since the implementation, monitoring and enforcement phase has not yet been developed for Case X – *SPTF's Universal Standards for Social Performance Management* – institutional supply is holding the balance between being limited and being extensive. Whereas the agenda setting and negotiation phase was characterized by extensive possibilities of participation, the implementation, monitoring and enforcement phase is still dominated by self-regulation of the MFIs and no enforcement mechanism is yet in place. At least, SPTF provides MFIs interested in implementing the universal standards with case studies that show how other MFIs have already implemented the universal standards (Wardle 2014, 10–24). There is further the option of applying CERISE's tool (SPI4) for MFIs to self-assess their compliance with the universal standards (CERISE 2016). In addition, MFIs can assign social rating agencies with the task of assessing the extent of their compliance with the universal standards (Social Performance Task Force 2014a, 13).

Regulatory Process Phase	**Main Actors**	**Participatory Channels**	**Institutional Supply**
Agenda Setting	• SPTF secretariat • SPTF elected board of directors • task force members • experts • MFIs • affected individuals	• first draft informed by existing social performance initiatives, research and data, and input from stakeholders over diverse participatory channels	*extensive*, the first draft however was put together by the SPTF secretariat
Negotiation of Standards	• SPTF secretariat • SPTF elected board of directors • task force members • experts • MFIs • affected individuals	• several rounds of consultations including, working groups, surveys, webinars, direct discussions with MFIs • SPTF's board of directors adopted changes to universal standards according to the inputs and ratified the reviewed standards	*extensive*
Implementation, monitoring, enforcement	• MFIs • rating agencies	• Implementation functions over self-regulation of MFIs, for example with CERISE's SPI4 tool • If wished by the MFI, monitoring and enforcement is conducted by rating agencies, however there is no standardized certification process in place yet	*limited*

Table 4: Extent of Institutional Supply: SPTF's Universal Standards for Social Performance Management

19.8 Societal Demand in Regard to the Four Cases

A few issues that raised public awareness in recent years fed the societal demand for regulatory change within the *UN Guidelines for Consumer Protection*, and especially for the financial services chapter. Although many countries already have consumer protection laws in the realm of financial services in place, an international standard is still lacking (Ardic, Ibrahim, and Mylenko 2011, 3). Considerable demonstration effects triggering extensive societal demand for regulatory change was the broad media coverage on the U.S. mortgage crises and the therewith-connected global financial crises starting in 2007. Another key function to promote regulatory change is ascribed to the growing financial inclusion of poorer and more vulnerable clients making use of financial services on a global scale that may need „a higher level of protection" (UNCTAD 2015a, §48; Benöhr 2013, 17). As can be read out from the 47 contributions made regarding the revision of the guidelines, especially NGOs, such as Consumers International (CI), were strongly involved in encouraging regulatory change in the direction of common interest (UNCTAD 2016). Pro-change forces that conflate their interest are key in order to effectively impact the formation of regulation. One of the biggest pro-change forces in the agenda setting and negotiation of standards phase was CI. As the world federation of consumer groups, CI has over 240 member organizations in 120 countries, and therefore may act as a powerful actor to effectively impact regulation formation (Consumers International 2016). However, the influence CI has in the implementation, monitoring and enforcement phase is limited as this part of regulatory formation is dominated by states. However, CI may act as nongovernmental entrepreneur for regulatory change. Since the UN discloses minutes and reports about the developments in regard to the guidelines and their implementation, CI can selectively act as watchdog. Other entrepreneurs of regulatory change cannot be identified; this seems at least to be the case considering the available documents.

Although CI already takes a big role in directing the guidelines in the direction of common interest regulation, there is still room to join forces with other players. In its contribution of how to revise the guidelines in 2013, CI has underlined the importance of the two 'new issues' – financial services and e-commerce – nevertheless, it has addressed other issues that gained less attention. In 1999 a sustainable consumption chapter, among other things, extended the guidelines but was never concretized with a notion of climate change. Such contributions offer room for other actors, such as sustainability and climate change interest groups, to increase their leverage in future debates about how to adapt the guidelines, join forces and raise pressure on crosscutting issues (Consumers International 2013, 3–4). In sum, societal demand for regulatory change regarding the UN Guidelines for Consumer Protection is rather broad than limited. Nevertheless, the societal demand cannot be leveraged over the whole regulatory process. A tradeoff has to be made in the critical phase of implementation, monitoring and enforcement, which remains dominated by the intergovernmental group of experts and therefore national states.

For the *UN Guiding Principles on Business and Human Rights* the societal demand for regulatory change is broad. „[N]egative externalities of no or poor regulation" are demonstrated by the extensive reporting on transnational corporations (TNCs) and their cross-border operations that sometimes cause terrible harm to the environment, their employees, or communities (Mattli and Woods 2009, 4). It is legally demanding to hold TNCs responsible for their actions in a country where they do not have their corporate headquarters. Furthermore, corporations still infringe on the human rights of their employees (e.g. forced labor, child labor, bad labor conditions, exposition of workers to hazardous substances), which is also frequently criticized by the media. The UN Guiding Principles on Business and Human Rights also address the responsibility of the states to protect human rights and should encourage corporations domiciled in their country to abide by human rights regardless of where they operate (OHCHR 2011). As already addressed when discussing the societal demand-side conditions in Chapter 19.1.2, the players actively participating to further regulatory change are diverse. Entrepreneurs of regulatory change are public officials like Ruggie fighting for participative options that are as wide as possible, nongovernmental entrepreneurs such as human rights NGOs, and other corporate entrepreneurs fighting to eradicate unequal treatment, namely that all corporations have to abide by the same catalogue of human rights. Unfortunately, much cannot be said about the influence of shared ideas on the extent of societal demand for regulatory change. However, the vast number of contributions from the public and private sector and the attendance of 60 country representatives, 8 intergovernmental organizations and 51 NGOs at the first session of the 'open-ended intergovernmental working group on transnational corporations and other business enterprises with respect to human rights' in July 2015 give a preliminary picture of the potential for future coalitions to jointly further regulatory change (Garcés 2015, Section B and Annex III).

The societal demand for regulatory change regarding the *Smart Campaign's Client Protection Principles and its Certification Program* is extensive within the microfinance industry. As was described earlier in this research project, over-indebtedness crises and especially the microfinance crises in Andra Pradesh, which was accompanied by a series of suicides committed by over-indebted farmers, served as demonstration effects and showed to a wider public that there is a need for regulatory change to mitigate over-indebtedness in microfinance. The media coverage was broad and the reputation of microfinance as an effective poverty reduction tool was seriously questioned (Bajaj 2011). There is a diverse set of stakeholders involved in the regulatory process of both the client protection principles and the certification program. Nongovernmental entrepreneurs of regulatory change (e.g. NGOs, microfinance networks, consumer protection organizations), public officials (e.g. representatives of national development agencies), and private sector actors (e.g. MFIs, investors, rating agencies) all take an active role in impacting the formation of the principles and the certification program, either as being consulted in one of the feedback rounds on the principles, or in one of the feedback rounds on the certification program. Although Smart Campaign is hosted at the Center for Financial Inclusion at ACCION, it is a new institution that was created out of different pro client protection initiatives. Assuming that structures had to be built up from the bottom, I propose that the demonstration effects described above had to be so powerful that a novel institution could be formed. The Smart Campaign's principles and certification program evolved over a relatively short period of two and three years respectively. Stakeholders had to have interests that pointed in the same direction, namely to enhance the protection of microfinance clients. Also the information spread about the devastating effects of over-indebtedness in several countries had a harsh impact on microfinance practitioners, development agencies, investors, funders but also on academics. Especially, the research conducted on the causes and wide-ranging consequences of over-indebtedness among microfinance clients questioned the prevailing conduct about over-indebtedness. Experiences in the field and research therefore challenged the status quo and created new sets of ideas that were shared by more and more stakeholders. These new insights provided a common ground to effectively urge change and made it possible that Smart Campaign's principles and certification program developed and concretized so quickly. In this case it was even possible that without established institutions and mechanisms this group of pro-change forces developed a standard setting institution almost from scratch.

The societal demand for regulatory change regarding the *SPTF's Universal Standards for Social Performance Management* is extensive within the microfinance industry. The demonstration effects (e.g. over-indebtedness crises, regulatory failures) that called for regulatory change were the same as the ones that triggered the wide societal demand in the case of Smart Campaign. Also the set of entrepreneurs for regulatory change was similar and sometimes overlapping with the one influencing the Smart Campaign's Client Protection Principles and Certification Program. Nongovernmental entrepreneurs of regulatory change, public officials, and private sector actors all took an active role in impacting the formation of the universal standards. They were, for example, involved as being a member of the task force, an elected member of the SPTF's board of directors, a MFI, an affected individual, an expert or investor consulted in one of the public comment rounds or pilot phase. The SPTF's Universal Standards of

Social Performance Management are one of the, if not the, youngest standards in the realm of client protection and social performance. Hence, they are still developing their processes for revisions of the standards, but also create new structures such as a possible certification program in the future. The SPTF was initiated from scratch and could not fit into an existing structure. Because new structures had to be formed, I propose, similar to the case of Smart Campaign that the demonstration effects described above had to be so powerful that a new institution could be formed. In a relatively short amount of time, the universal standards were developed and tested. Without all stakeholders aiming in the same direction and therefore having common interests, the streamlined process of the development and testing of the universal standards would have been less likely. The new ideas already spread by initiatives, such as Smart Campaign, were challenging the inexistence of client protection standards. SPTF was further motivated by the idea not only to promote a microfinance business conduct preventing clients from harm but also going further and actually „doing good", in the sense that the focus in microfinance should be on clients' benefits (Social Performance Task Force 2014b, 3). The demonstration effects and the existing microfinance initiatives showed where there is a need to close gaps, by for example synchronizing the revision procedures of different microfinance social performance initiatives, and maybe also by giving the various initiatives an umbrella organization. Due to the common ground of all stakeholders, also SPTF was able to establish an organization without any preexisting structures.

19.9 *Categorizing the Four Cases Within the Analytical Framework of Common Interest Regulation*

In the case of the *UN Guiding Principles on Business and Human Rights* the societal demand-side conditions are fulfilled and the institutional supply is rather extensive over the whole regulatory process. Also the implementation, monitoring and enforcement phase of the regulatory formation process allows for the participation of stakeholders. NGOs, experts, and state delegations are allowed to contribute at the regular meetings of the inter-governmental working group. Therefore, the UN Guiding Principles on Business and Human Rights can be labeled a common interest regulation (see [B] in Figure 7).

Smart Campaign's Client Protection Principles and Certification Program meets all the societal demand-side conditions and due to the different channels how stakeholders can participate of the entire regulation formation process also provides the necessary institutional supply to be categorized as common interest regulation (see [B] in Figure 7).

In the case of the *UN Guidelines for Consumer Protection* the societal demand-side conditions are met. The institutional supply-side conditions are extensive in the agenda setting stage, intermediate in the negotiation of standards stage, and limited in the implementation, monitoring and enforcement stage. Due to the fact that implementation and enforcement is still in the domain of states makes the UN Guidelines for Consumer Protection miss the mark of falling into the category of common interest regulation. Although it is likely that Consumers International (CI) and other NGOs undertake the function of watchdogs and use naming and shaming or other pinpricking strategies to pressure states to comply with the guidelines. The extent of pressure states receive might not be sufficient to further compliance. How the implementation and enforcement of the guidelines will develop will further greatly depend on how the mandate and work of the intergovernmental group and its subsidiary institutions develops. Preliminarily, I therefore categorize the UN Guidelines for Consumer

Protection as representing regulatory capture but with concessions and compromises (see [A] in Figure 7).

The societal demand-side conditions for the *SPTF's Universal Standards for Social Performance Management* are met. The institutional supply-side conditions are extensive in the agenda setting and the negotiation of standards stage, but implementation and enforcement mechanisms are still weak. For the SPTF's universal standards self-regulation by MFIs prevails and although there are possibilities, such as agency ratings, there is yet no standardized procedure. Until there is a certification process in place, the diverse stakeholders act as watchdogs and defecting MFIs are named and shamed. Preliminary, the SPTF's Universal Standards for Social Performance Management are best represented by regulatory capture with concessions and compromises (see [A] in Figure 7).

Figure 7 summarizes the results from the preceding analysis and shows the approximate positioning of the cases within the analytical framework.

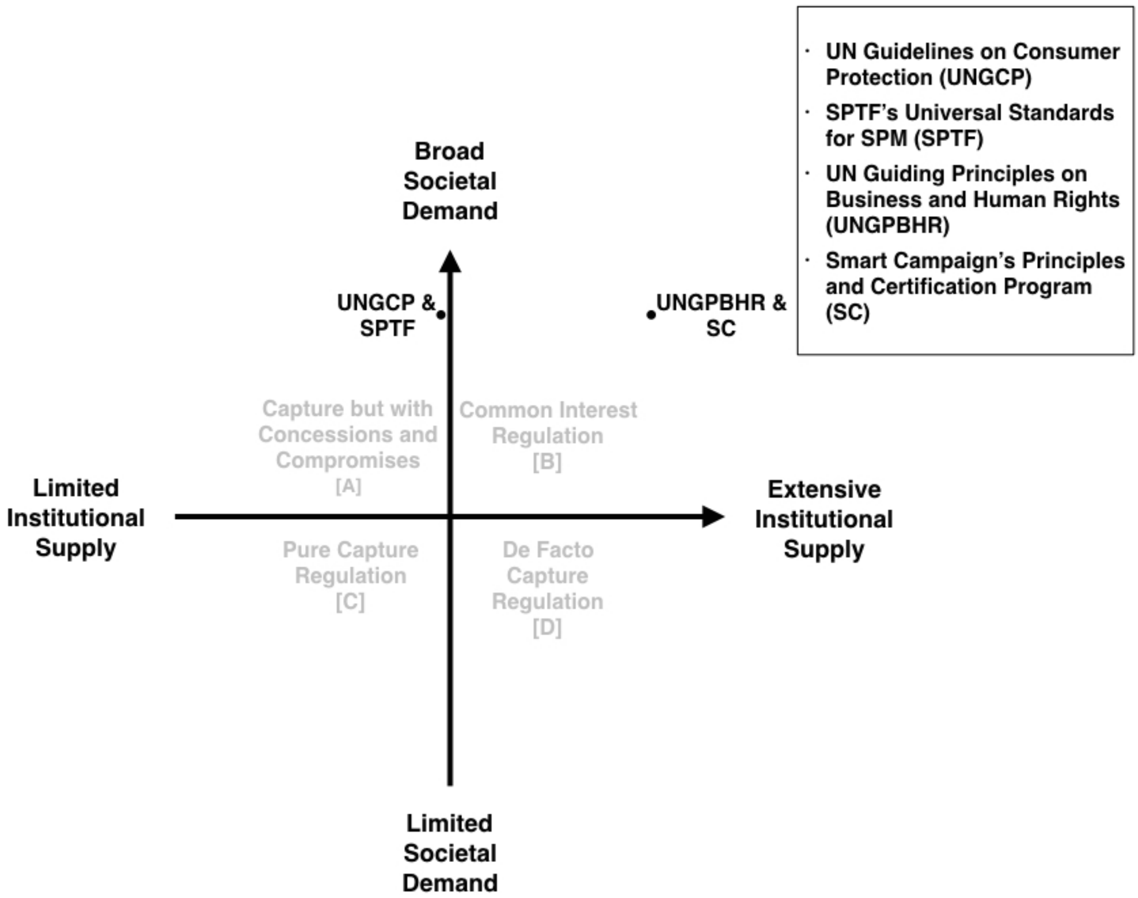

Figure 7: Regulatory Outcomes of the Four Analyzed Cases (own figure)

19.10 Applicability to the Responsible Microfinance Framework

Responsible microfinance starts with the assumption that clients stand at the center of microfinance and have to be protected from harmful practices. The soft law standards presented all aim to regulate business practices in such a way that they are not harmful. To be most effective for the framework of responsible microfinance, soft law standards should

1. be directed at and applicable to corporations and especially MFIs,
2. be widely accepted among states, civil society, MFIs, and investors,
3. include key standards for microfinance,
4. and should be enforceable.

The four soft law standards that have been examined above are examples of how clients could be protected from malpractice[96]. Furthermore, I analyzed whether these standards can be classified as to be in the common interest. To do so, I applied the analytical framework presented by Mattli Woods (2009). Although the societal demand for regulatory change was broad and sustained in all four cases, only the UN Guiding Principles on Business and Human Rights and the Smart Campaign's Client Protection Principles and its Certification Program provide extensive institutional supply over the whole regulatory formation process (see Table 2 and 3, and Figure 7). Due to the fact that the implementation, monitoring and enforcement processes regarding the UN Guidelines for Consumer Protection are still prerogatives to states, the institutional supply is only limited in this respect. Also for the SPTF's Universal Standards for Social Performance Management the implementation, monitoring and enforcement processes are still dominated by MFIs.

The *UN Guidelines for Consumer Protection* regulate what kind of measures states should take in order to reduce the risk of consumers falling victim to malpractice or hazardous products. The addressees are states so these standards could only be effective indirectly over the regulations states

[96] Thereby, the SPTF's Universal Standards for Social Performance Management go even further and additionally aim to create client benefits in the form of the betterment of their social and economic well-being.

implement. The guidelines can be altered and address financial services as a central issue regarding consumer protection. Although the language gained in vigor after the last revision of the guidelines, a mechanism to ensure or promote the enforceability of the Guidelines for Consumer Protection is still lacking.

The *UN Guiding Principles of Business and Human Rights* regulate the duties and responsibilities states and corporations have to protect and respect human rights respectively. Although the UN Guiding Principles on Business and Human Rights directly speak to TNCs and other businesses, it is questionable whether MFIs, and especially small ones, will fall under the Guiding Principles in the suggested binding treaty. Most probably the focus will lie on bigger corporations and TNCs. Furthermore, they do not include key standards for microfinance, especially if the intergovernmental working group decides to only let gross human rights violations trigger the binding treaty, the impact on microfinance will probably be minimal[97]. The guiding principles can be altered in a direction that is better applicable to microfinance, so it is possible that, depending on the scope of human rights that will be subject to the principles, microfinance clients could benefit from the protection given by such a soft law standard. Bearing in mind that the proceedings concerning the binding treaty are still in process, the guiding principles are not yet enforceable.

In contrast to the UN Guidelines for Consumer Protection and the UN Guiding Principles on Business and Human Rights, *Smart Campaign* builds a hard case for client protection in microfinance and could represent a cornerstone of the third pillar of the responsible microfinance framework. The Client Protection Principles have wide support by MFIs, networks and associations, investors and donors, supporting associations, and individuals (The Smart Campaign 2015d). Furthermore, the principles are directed at MFIs and include the key points I have worked out in Part II of this research endeavor. The extensive comment and deliberation phase slotted in ahead

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[97] They do not include key standards for microfinance (e.g. minimization of over-indebtedness, transparency in pricing), but they do at least address for example fair treatment and non-discrimination.

of every revision of the principles ensures the wide acceptability within the group of stakeholders. The revisions allow them further to answer to new developments. Additionally, the certification program gives, although it is not mandatory to run through, the possibility of hardening the soft law and therefore making the client protection standards enforceable. Unfortunately, only 46 out of 1600 MFIs that endorse the principles are also certified and thus evaluated on a regular bases in regard to their compliance with the principles (The Smart Campaign 2015d). So, strictly speaking the principles are enforceable but the effective enforcement of the principles has only been realized in 46 cases so far. Hence, when taking the majority of 1550 MFIs which endorse the principles but are not certified, still renders enforceability of the principles weak. One reason for the seemingly slow uptake of the certification program may be well connected to the high costs and requirements demanded of the MFIs. As already discussed above: If requirements are too high, MFIs might not be able – even if they wanted to – to become certified due to lack of knowledge, human capital, financial resources, or infrastructure.

Also the *SPTF's Universal Standards for Social Performance Management* are an important soft law standard within responsible microfinance. It directly addresses MFIs, is widely accepted and endorsed and includes key standards to protect microfinance clients. Beyond that, the universal standards go even further and not only include the Smart Campaign's Client Protection Principles but also an encompassing catalogue of social performance standards that especially targets the management practices, which are key to producing positive outcomes in regard to client benefits (Wardle 2014, 9). The breadth of the universal standards however also seems to have its restrictions. Although the standards are widely endorsed and the SPTF has almost 2800 individual and organizational members, the universal standards are only implemented by a limited number of MFIs. In fact, the SPTF expects MFIs to rather gradually implement the universal standards than to implement them all at once (Koning and Wardle 2014, 2). Exact figures of how many MFIs apply the universal standards are not available; however, the SPTF presents several case studies of MFIs, which have already implemented the universal standards (Wardle 2014, 10–24). Additionally, rating agencies start to assess the social performance of MFIs, taking the universal standards as a benchmark, but no standardized certification program is yet in place (Social Performance Task Force 2014a, 13). This notion leads to a critical point regarding the universal standards. They are, at the moment, not enforceable and therefore rather weak. The universal standards are encompassing, demanding, and represent a normative standard, which is hard to attain. In contrast to the Smart Campaign's Client Protection Principles, the implementation of the universal standards is likely to be even more costly with the additional disadvantage of not getting a standardized and yet not well-known certification. Furthermore, it seems to be already a big and expensive step for MFIs to commit to the client protection principles. To commit to the even more demanding catalogue of the universal social performance standards, even if MFIs wanted to, is probably unrealistic for many MFIs.

Due to its extensive institutional supply and wide societal demand, and its specific purpose, the *Smart Campaign's Client Protection Principles and its Certification Program* is the soft law standard that most easily fits into and applies to the framework of responsible microfinance. Setting a very high benchmark of how MFIs should ideally conduct their business also the SPTF's Universal Standards for Social Performance Management fit the framework of responsible microfinance. The standards fulfill the requirements of mediocre institutional supply during the whole regulatory process, which is due to the SPTF's not yet effective monitoring and enforcement system, and extensive societal demand. The standards are especially designed for microfinance and also encompass the most important points in regard to social performance management. However, they are still weak due to the high requirements they put on MFIs, which adds to causing slow uptake.

19.11 Interim Conclusion – Soft Law Standards

Being a framework of international scope, a focus was put on the applicability of soft law standards to the framework of responsible microfinance that were created on an international or transnational level. These voluntary standards optimally address key issues in a specific economic domain, in this case microfinance, and aim to be legitimate and enforceable. Assessing four cases of soft law standards against the backdrop of the analytical framework of the common interest regulation theory presented by Mattli and Woods (2009), it is shown that two of the cases can be labeled as common interest regulation (i.e. UN Guiding Principles on Business and Human Rights and the Smart Campaign's Client Protection Principles and Certification Program). Smart Campaign's principles and certification program are, however, best applicable to microfinance. Therefore, this analysis renders the Smart Campaign's Client Protection Principles and Certification Program the soft law standards best applicable to the framework of responsible microfinance.

Due to the capture by states prevalent in the implementation and enforcement phase in the case of the UN Guidelines for Consumer Protection and by MFIs respectively in the case of the SPTF's Universal Standards for Social Performance Management, these standards are considered capture regulations with concessions and compromises. Until there is no change in the institutional supply within the last regulation phase, international watchdogs (e.g. Consumers International (CI), NGOs and other advocacy organizations) take the position of putting pressure on states and MFIs to obey the UN Guidelines for Consumer Protection and SPTF's Universal Standards for Social Performance Management.

Looking at the four cases, it becomes clear that the extent to which the 'ordinary citizen' addressed by Dahl is able to participate in the establishment of these soft law standards is still limited. However, the cases are a precedent of the application of altered forms of traditional individual political participation on the transnational and international level. And as shown in the case of the UN Guiding Principles on Business and Human

Rights, the Smart Campaign's Client Protection Principles and Certification Program, and the SPTF's Universal Standards for Social Performance Management, there were possibilities for affected people to participate via interviews, focus groups, online consultations, and surveys. These forms of participation seem to provide the standard-setting procedures with a deliberative quality that can be framed as enhancing the legitimacy; the standards' acceptability and acceptance.

20 Conclusion

Part IV of this research project aimed at elaborating how a responsible microfinance framework could be established within which individual, and the therewith-connected institutional and systemic risks of over-indebtedness, can be mitigated. The overarching research questions for Part IV were the following:

- What could a framework of responsible microfinance look like?
- What are the possible actors involved and which practical strategies to mitigate over-indebtedness could they further?

Starting from the assumption that microfinance products have to be of a certain quality to mitigate over-indebtedness and accounting for the fact that not only the quality of services but also other aspects, such as psychological and cognitive biases, sociological influence factors, external factors, business malpractice, regulations and political interferences may, isolated or in combination, cause over-indebtedness, the main goal of Part IV was to develop a framework of responsible microfinance, and inform it with practical endeavors of how microfinance stakeholders could contribute to the mitigation of over-indebtedness. Responsible microfinance presumes that by means and combination of state regulation, financial literacy programs and soft law standards, over-indebtedness and the therewith-connected individual, institutional and systemic risks can be alleviated. The ten practical cases presented in Chapters 17 to 19 are a selection of strategies to potentially reduce over-indebtedness and therefore help enabling and enforcing the goals of responsible microfinance. They are summarized in the following figure.

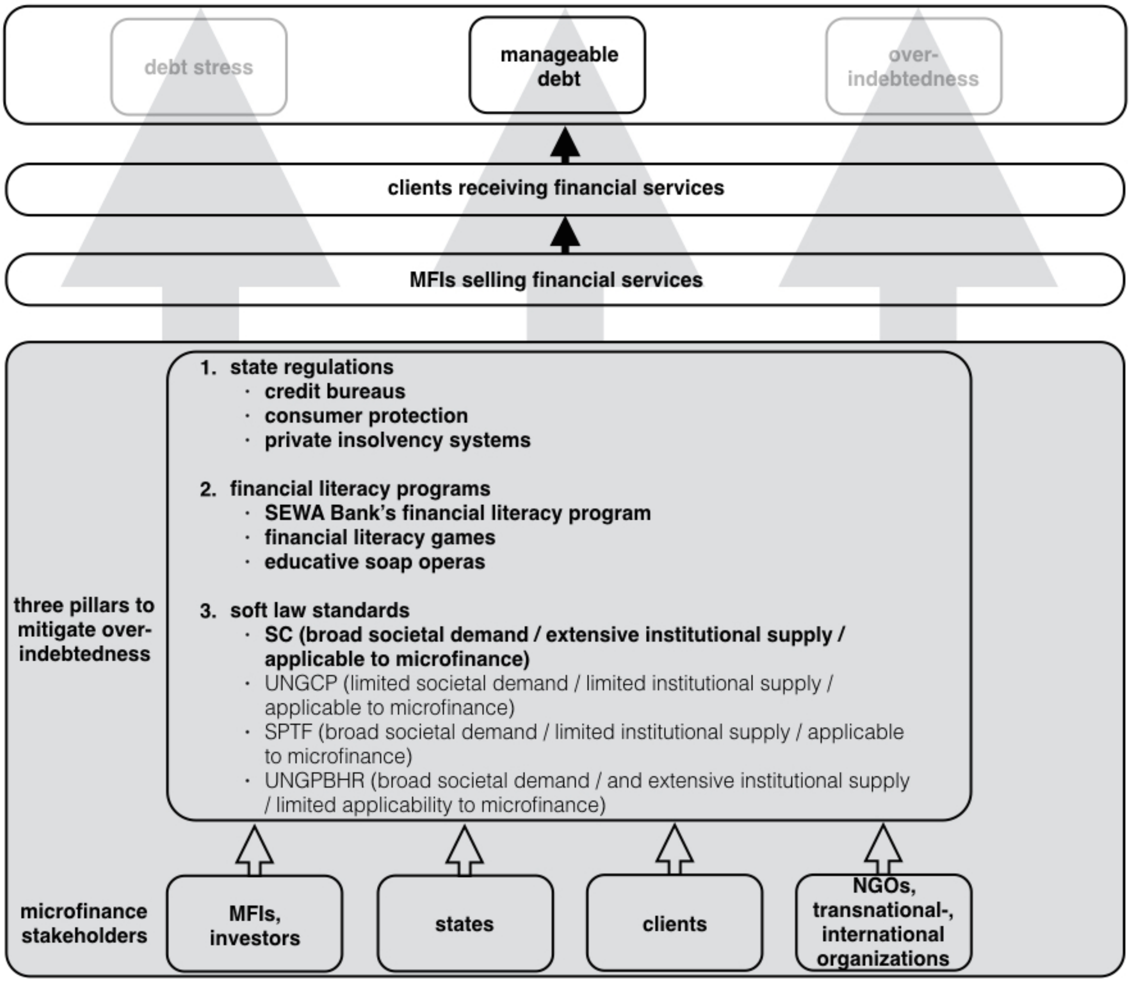

Figure 8: Multi-Stakeholder Framework of Responsible Microfinance Including Practical Strategies to Mitigate O-I

For every pillar the analysis of the causes and consequences of over-indebtedness suggested (i.e. state regulation, financial literacy programs, and soft law standards) three to four practical strategies that alleviate over-indebtedness were studied in order to demonstrate how responsible microfinance could be enhanced and implemented.

For the **first pillar**, three examples of how state regulation could mitigate over-indebtedness were presented. *Case I* starts from the assumption that microfinance clients' rationality is bounded. Claiming that client protection regulations should account for these limitations, it is outlined what requirements a national client protection regulation should meet. Deduced from empirical evidence there are three main characteristics consumer protection regulation should entail:

I. Disclosure requirements are the first characteristic. Although there is no 'one size fits all approach', literature agrees on simplifying and standardizing the microfinance product information, MFIs are specifically advised to disclose the APR and all additional costs incurred.

II. Fair treatment rules are the second characteristic. MFIs should treat clients in a non-discriminatory way and refrain from harmful practices (e.g. abusive lending practices, selling inappropriate products).

III. Accessible recourse systems are the last characteristic. Policy makers could contribute to this target and set clear rules about how, when and what to disclose. In the case of malpractice, recourse mechanisms are vital to give the clients an opportunity to voice their complaints[98].

Case II was concerned with credit bureaus as regulatory instruments to mitigate over-indebtedness. Pooling information systems provide MFIs with the credit records of their potential clients. Credit bureaus can be effective, if the information gathered considers negative as well as positive credit records and if as many MFIs (i.e. regulated and non-regulated) as possible share their information over such an information pooling system. The analysis revealed two difficulties. On the one hand, many countries still lack an encompassing credit bureau and instead MFIs voluntarily decide to share information among each other. This strategy often proves ineffective mostly due to incomplete information. On the other hand, as being an only recently discussed issue, data privacy of client data can be an obstacle in creating effective credit bureaus. In *Case III* private insolvency systems, as a very current but yet scarcely discussed issue in the context of microfinance and developing countries, are addressed. Private insolvency systems offer over-indebted households a 'fresh start' and could lift the stigma of being over-

[98] Ideally, a regulator-imposed third party offers possibilities for recourse. Third party recourse possibilities are currently still scarce. Hence, clients often have to resort to their MFI's internal dispute resolution.

indebted, as the cases of Egypt, Vietnam and Australia show, a private insolvency might still be problematic, especially when obstacles for being eligible for a debt relief program or re-entering the economy may be discouraging.

For the **second pillar**, three cases of how financial literacy alleviates over-indebtedness were addressed. In *Case IV* the financial literacy program of SEWA Bank was analyzed in order to understand how MFIs could educate their clients on the specifics of their products. SEWA Bank manages to gain in-depth knowledge about a client's financial situation and financial literacy (e.g. capital formation life-graph). Due to their effective information gathering system, SEWA may take the measures necessary to inform their clients about products with low capital expenditure. In *Case V* the Kenyan educational soap opera Mukatano Junction was introduced. Empirical evidence showed that educational soap operas can have a lasting and positive effect on viewers. In *Case VI* the topic of gamification was debated. Digital games and applications can be of great use in the context of microfinance. One particularly interesting game is the Shesha game developed by Absa, a South African MFI. Empirical evidence suggests a positive impact on the clients' knowledge about how to check their balances over their cell phone instead of undertaking costly long distance travelling to check their balances in the nearest MFI branch.

An especially strong focus was put on the **third pillar**. Four soft law standards, which all carry the potential to mitigate over-indebtedness were investigated. The aim of Chapter 19 was to show how applicable these standards are to the responsible microfinance framework and whether and to what extent these standards are established in the public interest. Transnational and international soft law is often criticized for being developed by few actors. Affected communities, NGOs, or other stakeholders when creating such standards were not taken into consideration for a long time. This, however, has changed with the Rio 'Earth Summit' in 1992. More and more, other stakeholders than state have been taken into consideration when establishing soft law. Accounting for these developments and having a client-centered understanding of microfinance, it seemed important to additionally analyze how clients and also other microfinance stakeholders are involved in the continuous development of these standards. In order to do so, I referred to the analytical framework of Mattli and Woods (2009), which evaluates whether a regulation can be categorized to be in the common interest. Among the four cases analyzed only *Case VIII* – the UN Guiding Principles on Business and Human Rights – and *Case IX* – Smart Campaign's Client Protection Principles and Certification Program are soft law standards which meet the requirements to be in the common interest. Additionally and due to their specificity, Smart Campaign's Client Protection Principles and Certification Program surfaced as the standards best applicable to the framework of responsible microfinance. They bear the highest potential to help mitigate over-indebtedness[99].

In Part IV of this research project the extended definition of microfinance in combination with the concretization of the concept of responsible microfinance and the three approaches to combat over-indebtedness (i.e. state regulation, financial literacy endeavors, soft law standards) were connected to an encompassing framework of responsible microfinance. Not only through singlehanded, but also coordinated and cooperative endeavors of microfinance stakeholders of the public and private sector the strategies presented contribute to the lasting protection of microfinance clients from over-indebtedness.

[99] Although very specific and even more comprehensive than the Smart Campaign's Client Protection Principles, the SPTF's universal standards revealed themselves as too demanding in the course of the analysis. They represent a normative ideal of a standard, which is hard to attain. Furthermore, they do not meet the requirements of the common interest regulation theory in order to be in the public interest.

CONCLUSION

21 Discussion of the Results, Overall Contribution, and Implications

The introduction of this study started with an excerpt from the first UN Human Development Report that heralded the start of a novel conception of development strategies from the 1970s onwards. Ul Haq argued that development strategies should be inclusive and should „create a conducive environment for people […] to develop their full potential and to have a reasonable chance of leading productive and creative lives in accord with their needs and interests" (1990, 1). Microfinance was long perceived such an inclusive development strategy. After years of concentrating on growth and outreach of microfinance it became clear that the 'microfinance promise' of the 1990s would not hold true. Especially the emergence of over-indebtedness, as one of the core problems of microfinance for the past two decades having far-reaching and devastating adverse effects on the individual, institutional, and market level, let microfinance scholars and practitioners alike demand for more client protection. Without denying microfinance its place within the realm of development cooperation and financial markets, I conducted an explorative and interdisciplinary study concluding that, in the light of the threat of over-indebtedness, there is a need to extend the current definition of microfinance by a quality-dimension and there is a further need to develop a comprehensive, protective, and multi-stakeholder framework of responsible microfinance. In doing so, my reasoning was based on theories, insights, and empirical evidence from the fields of political science and philosophy, economics, behavioral economics, psychology, law, and ethics.

Hereafter, I present brief conclusions of each of the four parts of this research, the overall contribution of this study and its practical implications, and directions for future research.

21.1 Concluding Remarks and Results

Providing the BoP with financial services is not trivial. MFIs have to deal with the information asymmetries inherent to every loan contract but in contrast to traditional banking cannot rely on securities. Microfinance loans are typically uncollateralized. Having no collateral to seize in case of default requires MFIs to use particular group- and individual lending methodologies, which help MFIs to curb their clients from defaulting. However, the growth focus of many MFIs has led to lax lending practices combined with aggressive marketing strategies. In the course of that many clients took on too much debt, which, in some markets, peaked in over-indebtedness crises. These crises served as demonstration effects of how devastating the consequences of over-indebtedness can be on the client level. Since also academics and microfinance practitioners started to call for enhanced client protection to prevent clients from suffering the detriments of such crises, it is questionable whether the current definition of microfinance captures these recent developments.

RQ I Is there ground to advocate an extension of the current definition of microfinance by a dimension accounting for how microfinance products should be provided?

In *Part I* and on the bases of three arguments, I developed an extended definition of microfinance, which includes a quality-dimension[100]. I claimed that the adherence of MFIs to certain client protection standards while supplying financial products is fundamental to microfinance.

[100] Microfinance is the provision of small-scale financial services to low-income individuals or low-income communities, small-scale meaning that the average outstanding balance of microfinance products does not exceed 250 percent of the averaging income per person (GNI per capita). Microfinance entails the supply of one or more of its principal components: credit, savings, insurance and money transfer [what-dimension]. The services are supplied by a microfinance institution that is either regulated or non-regulated [who-dimension]. Regarding the provision of its services, the microfinance institution complies with consumer protection standards and regulations, and therefore refrains from harmful practices [how-dimension/quality-dimension].

Part II started from the assumption that money is fungible after having entered a household and that a repaying household does not imply a debt-free household. Since MFIs supply uncollateralized loans, they apply specific lending methodologies to minimize information asymmetries. These strategies, however, serve a mere business purpose, namely to increase the probability of the MFI of being repaid. But being repaid does not say anything about the debt situation of the borrower at that time. The client could be paying back the loan with another loan of a different MFI. In fact she might be on the edge of being over-indebted, meaning that she continuously struggles to „meet repayment deadlines and repeatedly has to make unduly high sacrifices to meet her loan obligations" (Schicks 2010, 6). The dynamic of having no information about borrowers' financial situations and no collateral to seize in case of default, can render MFIs' portfolios increasingly at risks, which in turn might peak in entire markets losing stability. Aiming to find ways how to mitigate over-indebtedness and realizing that causes of over-indebtedness must be manifold and the consequences wide-ranging Part II contained a thorough analysis of these causes and consequences in order to deduce possible approaches to fight against over-indebtedness.

RQ II What approaches are suited to minimize over-indebtedness?

The analysis showed that the number of over-indebted clients is not only dependent on whether the MFIs supply their services abiding by certain client protection standards but also on an interplay of many factors, such as psychological and cognitive biases, sociological influence factors, external factors, regulations, and political interferences. Over-indebtedness adversely impacts the social and economic well-being of borrowers and may also negatively influence the financial sustainability of MFIs and the overall market stability. Acknowledging the manifold causes and wide-ranging consequences that over-indebtedness brings along, it was suggested that microfinance stakeholders could minimize over-indebtedness from different angles and therewith protect microfinance clients. By doing so the negative spill over effects on MFIs and markets could be alleviated as well. The analysis revealed that three specific approaches are suitable to fight over-indebtedness: state regulation, financial literacy programs, and soft law standards.

Getting an in-depth understanding of the causes and consequences of over-indebtedness had served to emphasize the centrality this issue takes in microfinance and to connect the extended definition of microfinance, which demands MFIs to protect their clients from harmful practices, to a comprehensive framework including tangible strategies to fight against over-indebtedness.

In *Part III* it was argued that the extended definition of microfinance in combination with the three strategies to face over-indebtedness could be connected to an encompassing framework, which potentially adds to the protection of microfinance clients from over-indebtedness: the 'multi-stakeholder framework of responsible microfinance'. It is a coordinated and cooperative effort to enable and enforce responsible microfinance and incorporates three pillars: state regulations, financial literacy programs, and soft law standards.

Instead of starting with the analysis of how a responsible microfinance framework could be enabled and enforced, I began Part III with defining what responsible microfinance was and how its overall demand of responsibility could be interpreted. The primary goal of Part III was therefore to define the concept of responsible microfinance, and to substantiate the framework with an approach to responsibility.

RQ III What is responsible microfinance and how could responsibility be interpreted in this context?

Besides its overall call for responsibility[101], responsible microfinance was introduced in Chapter 13 as having three specific demands:

I. MFIs balance their social and financial performance.

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[101] Responsible microfinance presupposes that due to the microfinance clients' vulnerability, microfinance's social mission, and the risks over-indebtedness entails on the individual, institutional, systemic level, microfinance stakeholders have a responsibility to alleviate over-indebtedness.

II. Microfinance stakeholders contribute and cooperate in order to enable and enforce responsible microfinance.

III. Microfinance stakeholders have a general responsibility to mitigate over-indebtedness, and MFIs are specifically required to hold themselves responsible for achieving their social mission, which includes client protection and managing their social performance.

After having given a definition of responsibility[102], a short overview of the different responsibilities emerging for microfinance stakeholders, such as the responsibilities the MFI has towards its clients, its employees, its investors, and also towards business standards it obeys, was presented. Dwelling on the demand that MFIs should hold themselves responsible to fulfill their social mission the question arose whether MFIs, which commit themselves to responsible microfinance, could be held responsible for their deviance. Referring to Pettit (2007b) it was shown that corporations could be, at least morally, held responsible for their wrongdoing.

Responsible microfinance is still a very young concept that needs more work. Part III contributed to the development of a common definition of responsible microfinance and to an initial concretization of the meaning of responsibility in this context. Additionally, Part III added to the discussion about responsible microfinance's continuing development. Narrowing down the interpretational range of what responsibility means in this context potentially enhances the enforcement power of soft law standards regarding the potential to minimize exit options and deflecting.

In *Part IV,* I explored ten cases that enable and enforce responsible microfinance. The multi-stakeholder framework of responsible microfinance demands that its goals are enabled and enforced via a cooperative and coordinated effort by microfinance stakeholders. To alleviate over-indebtedness, the framework foresees three approaches or pillars: state

[102] Responsibility is defined as an obligation or duty to satisfactorily perform or complete a task that we either commit ourselves to, in the sense of a promise, or that we are appointed to from an authority, in the sense of an exogenous assignment (Bentham 1970, 294; Raz 1988, 82; Simmons 1979, 76). Not fulfilling that obligation implies the appropriateness of a sanction be it a legal or social one.

regulations, financial literacy programs, and soft law standards. In order to present tangible strategies of how to mitigate over-indebtedness in practice, I explored three to four cases for each pillar in Part IV. The overarching research questions for Part IV were:

RQ IV What could a framework of responsible microfinance look like?

RQ V What are the possible actors involved and which practical strategies to mitigate over-indebtedness could they further?

As argued in Part II, the causes of over-indebtedness are manifold and mirror that there is no 'one size fits all approach' to mitigate over-indebtedness. The main target of Chapters 16 to 19 was to additionally sharpen the framework of responsible microfinance and to demonstrate that only a mixture of efforts by states, MFIs, clients, NGOs, and investors can actually help to enable and enhance responsible microfinance. The ten practical strategies presented in Chapters 17 to 19 are a selection of hard cases that aim to mitigate over-indebtedness by means of state regulations, financial literacy programs, and soft law standards.

For the first pillar, three examples of how state regulation could alleviate over-indebtedness were explored. Demanding that client protection regulations should account for the bounded rationality clients have, it was outlined in *Case I* what requirements a national consumer protection regulation should meet (i.e. disclosure requirements, fair treatment rules, accessible recourse systems). Credit bureaus as regulatory instruments to alleviate over-indebtedness were the focus of *Case IV*. The effectiveness of credit bureaus highly depends on the type of information gathered and the type of MFIs allowed to provide information to the credit bureau. The information should permit negative and positive entries and as many MFI types as possible should be able to provide credit information. In *Case III* private insolvency systems were analyzed. They could offer over-indebted households a 'fresh start' and could lift the stigma of being over-indebted.

For the second pillar, three cases were explored of how financial literacy programs could mitigate over-indebtedness. The financial literacy program of SEWA Bank was discussed as *Case III*. SEWA Bank gathers in-depth information about their clients, by means of capital formation life-graphs, in order to adequately inform their clients about their financial services. Having that in-depth knowledge can help to detect debt stress and protect clients from over-indebtedness. The Kenyan educational soap opera 'Mukatano Junction' was addressed as *Case IV*. I presented empirical evidence showing that educational soap operas can have positive effects on viewers and their knowledge about over-indebtedness. As was shown in *Case V,* digital games and applications can be beneficial in the context of microfinance. In the specific example of the Shesha Game, I presented evidence suggesting a positive impact on the clients' knowledge about how to check their balances and have an overview of their finances.

The strongest focus was put on the third pillar. The aim was to analyze four soft law standards, which all bear the potential to alleviate over-indebtedness, and to demonstrate their applicability to microfinance and if and to what degree these standards were established in the common interest (Mattli and Woods 2009). Only *Case VIII* – the UN Guiding Principles on Business and Human Rights – and *Case IX* – the Smart Campaign's Client Protection Principles and Certification Program could be classified as common interest regulation. Due to their applicability to the microfinance context, Smart Campaign's Client Protection Principles and Certification Program fit the framework of responsible microfinance best and therefore bear great potential to help mitigate over-indebtedness.

Part IV of this study linked the extended definition of microfinance (Part I) in combination with the enhanced understanding of 'responsibility' within the concept of responsible microfinance (Part III) and the three approaches to combat over-indebtedness (Part II and IV) to a comprehensive multi-stakeholder framework of responsible microfinance. The practical cases discussed demonstrate that over-indebtedness can be addressed and mitigated through singlehanded or coordinated and cooperative undertakings of microfinance stakeholders.

21.2 Overall Contribution

This study is of an explorative character and therefore generalizing and comparing its results is difficult. However, the less structured methods applied in this research project allowed for an in-depth and contextual understanding of the role of client protection in microfinance, the phenomenon of over-indebtedness, the concept of responsible microfinance, and the practical strategies a multi-stakeholder framework of responsible microfinance could offer in order to mitigate over-indebtedness.

There are four main contributions of this study. *First,* although there were several researchers and practitioners advocating enhanced client protection in microfinance there was no claim to integrate client protection into the definition of microfinance. I presented reasons why the current definition of microfinance should be extended and incorporate a quality-dimension requiring MFIs to abide by client protection standards. *Second,* responsible microfinance being an exclusively practice oriented concept lacked a common definition. I concretized the concept and shed light on the possible meaning and functions 'responsibility' could have in responsible microfinance. *Third,* extending the definition of microfinance by adding a quality-dimension and connecting this understanding of microfinance to an encompassing multi-stakeholder framework of responsible microfinance is a novel approach and contributes to and concretizes a conception of how to conduct microfinance responsibly in the light of the threats over-indebtedness poses to clients, MFIs, and microfinance markets. *Fourth*, I elaborated on a selection of strategies of how to enable and enforce the multi-stakeholder framework of responsible microfinance in practice. I analyzed not only well-known, but also rarely discussed strategies to mitigate over-indebtedness and present the central implications that thereby surfaced below.

21.3 Implications for Practice and Direction for Future Research

There are mainly three implications for practice that go beyond what has been addressed in this research project, and these implications are linked to directions future research could take in order to further contribute to concretizing a multi-stakeholder framework of responsible microfinance. The three implications are:

I. building a supervisory board for the third pillar of the framework of responsible microfinance,
II. capitalizing the role of investors and their leverage to enable and enforce responsible microfinance, and
III. enhancing the coordination between the efforts of microfinance stakeholders to mitigate over-indebtedness.

Building a Supervisory Board for Pillar III

The definition of responsibility introduced in Chapter 14 states that we either commit ourselves to a responsibility, in the sense of a promise, or that we are appointed to a responsibility from an authority, in the sense of an exogenous assignment (Raz 1988, 82; Simmons 1979, 76). However, this research project does not address what the character of this 'authority' is. Who is entitled to assign MFIs with a duty? And, who is legitimate to detect that a certain MFI has failed to fulfill its duty and to impose a sanction? As argued in Chapter 14.4 holding a person or corporation responsible includes actually blaming or approving this person or corporation. In the case of wrongdoing, eschewing the blame denies that there is a creditor: That there is „someone to whom at least an apology is owed" (Pettit 2007b, 174). The lack of a legitimate authority that has not only the mandate to assign responsibility to MFIs but also to declare breaches of MFIs often results in no one actually blaming contravening MFIs.

In Chapter 19.4 and 19.5 it has been shown that the two standards most applicable in the realm of microfinance – Smart Campaign's Client

Protection Principles and Certification Program and SPTF's Universal Standards for Social Performance – both showed lack of enforceability. There are two possibilities of how to approach this issue and enhance enforceability in the future. In Chapter 19.5 and 19.7, it was discussed that SPTF, Smart Campaign and CERISE already work closely together. They, for example, synchronize the revision processes of their tools and principles. These main players all representing institutions that further the goals of responsible microfinance, could form an overarching control organ, for example, an elected supervisory board within the framework of responsible microfinance, which is authorized by the endorsers of SPTF, Smart Campaign and CERISE to criticize but also praise business practices of endorsers. On the one hand, MFIs that cannot afford a certification but nonetheless strive to implement client protection and social performance management into their day to day business, are given the opportunity to prove their abidance despite the lack of certification. On the other hand, MFIs that endorse Smart Campaign's principles and SPTF's universal standards but do not act accordingly could be criticized for their conduct. In order to detect harmful practices more easily there is the option to have National Contact Points (NCPs) in place. The OECD, for example, requires all countries adhering to the 'OECD Guidelines for Multinational Enterprises' to have NCPs in place. NCPs' roles are to „further the effectiveness of the Guidelines by undertaking promotional activities, handling enquiries, and contributing to the resolution of issues that arise from the alleged non-observance of the guidelines in specific instances" (OECD 2016). Such a system could work well in the context of responsible microfinance. The size and complexity of such a system though would have to be adapted to the size and complexity of the worldwide microfinance market. The most demanding task remains, and that holds true for any regulatory framework that claims enforceability, the actual implementation, monitoring and enforcement is key to ensure that standards are not „empty promises that undermine trust" (Brix and McKee 2010, 19).

Capitalizing the Role of Investors

I marginally addressed the role of investors in regard to using their leverage in order to enforce responsible microfinance. Investors putting their money into microfinance (e.g. private equity, lending money) could condition their investments on certain standards that have to be met[103]. If the MFI does not abide by the terms agreed upon, the investor might increase the cost of the loan. In fact, a survey conducted by SPTF shows that investors already incentivize MFI's to abide by soft law standards by giving the MFIs preferential terms if they do so (Social Performance Task Force 2014c, 9). Also Brix and McKee (2010, 21) more generally state that investors can improve the double bottom line of the MFI, so that especially the social performance is enhanced. They further argue that the leverage of the investor should not be misjudged and actually is often considered a better incentive for adequate business conduct of MFIs than the threat of regulatory intervention. Additionally, Argüello et al. (2013, 190) cite Guillermo Salcedo, current Deputy Director Credit at Oikocredit International, that they „would never fund an organization that is purely commercial. If there is no social value, we wouldn't fund it". This statement resonates with all interviewees Argüello et al. consulted. Hence, there already seem to be several investors conditioning their investments on the social performance of MFIs.

[103] Funders range from institutional investors putting their money mainly into formal MFIs to NGOs funding smaller and semi-formal MFIs. All investor types could use their leverage to incentivize responsible microfinance practices.

Enhancing Coordination

As shown in Part IV, cooperation between various microfinance stakeholders is established within all of the pillars of responsible microfinance. However, the coordination between the three pillars is widely non-existent. This fact is partly owed to the framework of responsible microfinance still being in its infancy but microfinance summits bringing public and private actors together, and collaboration, such as the one between Smart Campaign, SPTF and CERISE in regard to synchronizing revision processes, can address and minimize coordination problems and render the framework of responsible microfinance more effective.

APPENDIX

Savings Products

Savings products are vital for MFIs. They help them to reach self-sustainability and, in the case of compulsory savings, they insure the MFI against defaults. Furthermore, savings are also beneficial for clients. After reaching a certain amount, savings serve as collateral for larger loans. Also it enables microfinance clients to insure themselves against sudden shocks, such as natural disasters, death, illness or payment for events, such as tuition or self-finance investments (Armendáriz and Morduch 2010, 174–175). Robinson (2001, 21) even claims that savings are more valuable to the client than credit.

Savings can be roughly categorized into compulsory and voluntary savings. In many countries the regulatory status of the MFI determines whether it is allowed to take deposits. It is often the case that solely MFIs with a banking license may offer voluntary savings products.

The main voluntary savings products are: current accounts without restrictions and contractual savings products with a savings plan and interest on the deposited amount (La Torre and Vento 2006, 28–29). MFIs that do not operate under banking law can merely offer compulsory savings. Compulsory savings are forced savings and technically do not count as deposits. They serve as an alternative form of collateral for a loan and are retained as long as the client is in arrear with his or her payments (Morduch 2000, 626; Armendáriz and Morduch 2010, 173).

Insurance Products

The BoP is at the mercy of all kinds of risks, such as natural disasters, illnesses or droughts. Mostly they lack insurance and suffer great losses due to the lack of reserves (Cohen and Sebstad 2005, 397).

Microinsurance products aim to reduce the vulnerability to outer shocks (Arun et al. 2005, 308). The product variety ranges from life-, property-, weather- to health insurance (Armendáriz and Morduch 2010, 195–201).

In literature, the provision of insurances in microfinance is widely criticized (Armendáriz and Morduch 2010, 195; Cohen and Sebstad 2005, 402; La Torre and Vento 2006, 31), especially due to the common combination of insurance products with credit and savings, which may lead to concentrated risks (La Torre and Vento 2006, 31). Also, microinsurance products face the same imperfect information problems there are with microcredits. TCs are very high and enforcing insurance contracts is difficult (Armendáriz and Morduch 2010, 195, see also discussion about information asymmetries in 5.3.2.1).

Money Transfer

Money transfer – also named payment services, or fund transfer – allows people to send money from one destination to another via a secure channel. Clients that use this form of transfer, favor sending money in an alternative form to cash (Isern, Donges, and Smith 2008, 96). Money transfer is simple and safe; the prices of these products can however greatly differ. The money is quickly transferred to the desired destination and may be paper-based (e.g. checks), card-based (e.g. debit card), or transferred electronically (e.g. e-banking) (Isern, Donges, and Smith 2008, 61, 100–109). Either MFIs have their own payment services products or they cooperate with common global providers such as Western Union and MoneyGram or commercial banks.

Funders of Microfinance

From the 1980s on, MFIs were still dependent on subsidies in order to keep up their operations. This changed a decade later when the financial self-sufficiency of MFIs came into focus and institutions strived to avoid soft loans and interest free grants given by donors (e.g. foundations, development agencies) (Armendáriz and Morduch 2010, 323). Soft loans characteristically have subsidized interest rates[104] and are commonly provided by aid agencies (e.g. UK Department for international Development), apex institutions (e.g. Women's World Banking, ACCION) or multilateral banks (e.g. The World Bank). With the enhanced focus on growth and financial sustainability in the 1990s, also institutional investors channeled their funds into microfinance markets (Armendáriz and Morduch 2010, 254–256). This is achieved through microfinance investment vehicles (MIVs) that „invest all or part of their assets in microfinance institutions" (Armendáriz and Morduch 2010, 254). Furthermore, MFIs try to operate financially sustainably with their own means. Except from the provision of training - which is normally free - interest rates, savings and fees are fundamental sources of income for the MFI (La Torre/ Vento 2006: 35).

Despite efforts to reach financial sustainability, subsidies do not lose their importance in microfinance. Grants and soft loans play their part and although they should not subsidize „ongoing operations", they may be valuable for MFIs to foster their start-up phase, to support non-profit services that MFIs provide (e.g. impact data collection that might benefit also others) for institution building (e.g. introducing a new management information system) or for educational training (e.g. business development, health, finance), the MFI might offer (Armendáriz and Morduch 2010, 333–334).

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[104] Armendáriz and Morduch (2010, 322–323) take the Grameen Bank as an example showing that from 1985 to 1996 the nominal interest rate per year it had to pay was around 3.8 percent. After adjustments for inflation are subtracted, -1.8 percent per year were left to pay. In comparison, when lending from commercial banks it would have to pay more than 10 percent per year.

The following figure illustrates the financial in- and outflows of an MFI and summarizes how MFIs are funded.

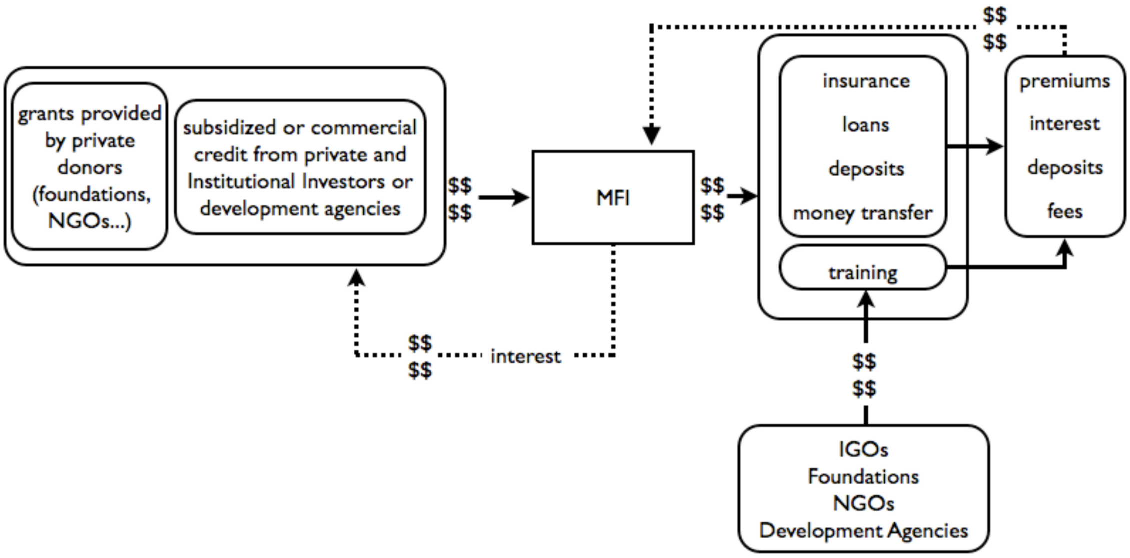

Figure 9: Financial In- and Outflows of MFIs (Landolt 2009, 8)

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